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### Securitization and Suburbia

Heather Hughes

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## *Articles*

HEATHER HUGHES\*

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*This Article explores the relationship between one typical form of real estate development finance—the securitized mezzanine loan—and one controversial phenomenon—suburban sprawl. It asks foundational questions about the connection between financial transactions and real-world applications of the capital they raise. In this work, sprawl serves as an example of an environmental consequence of applications of capital raised with a common form of transaction. This Article considers the extent to which commercial finance laws release forceful incentives driven by capital markets upon land use decisions, potentially undermining the collective, morally informed determination such decisions require. It rejects the aesthetic aversion to looking beyond transactional structures in the abstract to consider what results as commercial actors use typical deals to fund typical growth patterns. To the extent that standardized forms of financial transactions fund recurring land uses that many find problematic, the terms and structures of the transactions themselves should be a subject of critical inquiry.*

## INTRODUCTION

Intense debates surround the environmental and cultural desirability of the sprawling suburbia that characterizes so much American landscape.<sup>1</sup> This Article explores the extent to which this landscape is a function of dominant patterns and path dependencies in finance.

“Suburban studies” is an evolved, multidisciplinary project that engages suburbia as everything from an economic phenomenon to an architecture, a politics, or a mode of cultural production, to name a few.<sup>2</sup> While others have observed that suburbanization and debt finance are intertwined, this Article takes the step of directly relating contemporary financing practices to land-use results on the ground.

Many environmentalists object to new low-density developments, especially when the developments consume previously undeveloped land. Yet, deep mystery surrounds the coexistence of our love of nature and our indifference to its destruction.<sup>3</sup> Home buyers may have a range of values and objectives that include commitments to open space yet purchase a new home in a sprawling area in response to other pressures. Purchasing a new home is not simply an expression of preference for the house over other values. The age-old philosophical problem that we simultaneously love and destroy the natural environment refracts the preferences even of a consumer committed to an evolved environmental ethic.

Ultimately, this Article considers the extent to which commercial finance laws release the forces of individual profit motive and capital-market-driven incentives upon collective decisions about growth and development that require delicate, morally informed determination.

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<sup>1</sup> See *infra* text accompanying notes 86–91, 97–100.

<sup>2</sup> See Nicole Stelle Garnett, *Save the Cities, Stop the Suburbs?*, 116 YALE L.J. 598 (2006) (reviewing ROBERT BRUEGMANN, *SPRAWL: A COMPACT HISTORY* (2005); JOEL KOTKIN, *THE CITY: A GLOBAL HISTORY* (2005)); Andrew Reynolds, *Disneyfied Sprawl, Blue-Collar Bogeysmen, and Bourgeois Jeremiads: The Legacy of Investment in Suburbia*, 56 AM. Q. 1067 (2004) (reviewing DOLORES HAYDEN, *BUILDING SUBURBIA: GREEN FIELDS AND URBAN GROWTH, 1820–2000* (2003); CATHERINE JURCA, *WHITE DIASPORA: THE SUBURB AND THE TWENTIETH-CENTURY AMERICAN NOVEL* (2001); SETH M. LOW, *BEHIND THE GATES: LIFE, SECURITY, AND THE PURSUIT OF HAPPINESS IN FORTRESS AMERICA* (2003)).

<sup>3</sup> See generally SHIERRY WEBER NICHOLSEN, *THE LOVE OF NATURE AND THE END OF THE WORLD: THE UNSPOKEN DIMENSIONS OF ENVIRONMENTAL CONCERN* (2002) (exploring the dimensions of experience with nature that remain unspoken, in an effort to understand how appreciation of the beauty of nature and indifference to its ruin can coexist).

For example, while environmental policies attempt to control rapid consumption of open-space land,<sup>4</sup> commercial finance laws facilitate real estate developers' capacity to build as many new developments as fast as the market will bear.<sup>5</sup> Zoning and other local government measures designed to promote "smart growth," along with environmental regulation and property devices like the conservation easement, have attempted to slow the disappearance of open space.<sup>6</sup>

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<sup>4</sup> Though definitions of "open-space land" can vary, the concept of open space centers around natural resources that perform essential ecological functions and provide benefits to people. The U.S. Department of Agriculture (USDA) offers the following definition: "Open space includes natural areas such as forests and grasslands, as well as working farms, ranches, and timberlands. Open space also includes parks, stream and river corridors, and other natural areas within urban and suburban areas. Open space lands may be protected or unprotected, public or private." FOREST SERV., U.S. DEP'T OF AGRIC., *Loss of Open Space*, OPEN SPACE CONSERVATION, [http://www.fs.fed.us/openspace/loss\\_space.html](http://www.fs.fed.us/openspace/loss_space.html) (last visited Nov. 9, 2011). Other jurisdictions may define "open-space" slightly differently. For example, the State of Virginia defines "open-space land" as

any land which is provided or preserved for (i) park or recreational purposes, (ii) conservation of land or other natural resources, (iii) historic or scenic purposes, (iv) assisting in the shaping of the character, direction, and timing of community development, (v) wetlands as defined in §28.2-1300, or (vi) agricultural and forestal production.

VA. CODE ANN. § 10.1-1700 (West 2011).

<sup>5</sup> The recent slow-down in U.S. housing markets does not change the long-term population and development projections that threaten open-space land. The USDA currently reports that "[o]pen space is being lost at an alarming rate—almost 6,000 acres of open space are converted to developed uses every day." FOREST SERV., U.S. DEP'T OF AGRIC., *supra* note 4. Though not all open-space land is forested, forests comprise a substantial amount of open space. A recent report by the U.S. Forest Service states that fifty-six percent of the nation's forests are privately owned, amounting to 420 million acres; of that number, fifty-seven million acres face a serious threat from housing development in the next twenty years. See SUSAN M. STEIN ET AL., FOREST SERV., U.S. DEP'T OF AGRIC., GEN. TECHNICAL REP. PNW-GTR-795, *PRIVATE FORESTS, PUBLIC BENEFITS: INCREASED HOUSING DENSITY AND OTHER PRESSURES ON PRIVATE FOREST CONTRIBUTIONS* 3, 13 (2009), available at <http://www.fs.fed.us/openspace/fote/benefits.html>. An August 2010 USDA press release states,

Private forests that play a critical role in supplying our nation with clean water resources, and the timber we need to build homes and communities across the country will be threatened. A number of species including the already-endangered Florida panther and the grizzly bear are also expected to be put at risk because of loss of forested land.

Press Release, Forest Serv., U.S. Dep't of Agric., Release No. 0401.10, Vilsack Highlights Report Showing Threats to Private Forested Lands (Aug. 11, 2010) (on file with author).

<sup>6</sup> See generally Patricia E. Salkin, *Squaring the Circle on Sprawl: What More Can We Do? Progress Toward Sustainable Land Use in the States*, 16 WIDENER L.J. 787 (2007) (discussing the recent state and local strategies for encouraging growth patterns that do not aggravate sprawl and its environmental problems). For a discussion of current responses to persistent problems in land use regulation, see Nicole Stelle Garnett, *Unbundling*

Yet, these efforts swim against a current of capital that responds to commercial finance law.

The increase in practices like mortgage securitization in recent decades has coincided with an increase in average home size and in the number and uniformity of suburban developments.<sup>7</sup> That there is a relationship between financing practices that facilitate home building and buying, on the one hand, and the issue of suburban sprawl, on the other, seems obvious.<sup>8</sup> But defining this relationship is remarkably difficult. This Article takes up the challenge.

Sprawl implicates many questions, including the desirability of open-space consumption. The purpose of this inquiry is not to argue that suburban sprawl is a problem. Rather, it is to present a phenomenon that incites intense debate and raises persistent questions about our relationship to the natural environment, and then to relate that phenomenon to commercial finance rules that govern the transactions that fund it.

What is a private-law problem, and what is not? *Uniform Commercial Code* (UCC) Article 9<sup>9</sup> facilitates secured debt finance without regard to whether such finance alleviates or aggravates environmental concerns. Does secured-transactions law itself escalate

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*Homeownership: Regional Reforms from the Inside Out*, 119 YALE L.J. 1904 (2010) (reviewing LEE ANNE FENNELL, *THE UNBOUNDED HOME: PROPERTY VALUES BEYOND PROPERTY LINES* (2009)).

<sup>7</sup> See ANDRÉS DUANY ET AL., *SUBURBAN NATION: THE RISE OF SPRAWL AND THE DECLINE OF THE AMERICAN DREAM* 41 (2000) (stating that “[d]ollar for dollar, no other society approaches the United States in terms of the number of square feet per person, the number of baths per bedroom, the number of appliances in the kitchen, [and] the quality of the climate control”); DOLORES HAYDEN, *A FIELD GUIDE TO SPRAWL* 110 (2004).

<sup>8</sup> See, e.g., Eduardo Penalver, *This Could Mean the End of the Exurbs*, DALLAS MORNING NEWS, Jan. 7, 2008, at A13 (stating that the financial crisis may halt continuing suburbanization of ex-urban areas). For a discussion of “sprawl,” see *infra* Part IIA.

<sup>9</sup> U.C.C. § 9 (2005). For a discussion of the scope of Article 9 and the wide range of transactions it governs, including its relationship to securitization and to real estate finance, see *infra* Part I.B. UCC Article 9 governs transactions in which a creditor makes a loan and takes as collateral a lien on personal property of the debtor. *Id.* § 9-109. A lien is a type of property interest. Security interests are liens created by contract—consensual liens. The National Conference of Commissioners on Uniform State Laws (NCCUSL), in conjunction with the American Law Institute (ALI), convenes committees to draft the UCC. See 1 *UNIFORM COMMERCIAL CODE: DRAFTS* xv (Elizabeth Slusser Kelly ed., 1984). All U.S. states have enacted UCC Article 9. UCC Article 9 Amendments (2010), UNIFORM LAW COMMISSION, [http://www.uniformlaws.org/Act.aspx?title=UCC%20Article%209%20Amendments%20\(2010\)](http://www.uniformlaws.org/Act.aspx?title=UCC%20Article%209%20Amendments%20(2010)) (last visited Nov. 18, 2011). Unless otherwise indicated, citations herein to the UCC are to the official text and comments of the ALI and NCCUSL.

certain forms of commercial activity that can aggravate environmental harms? If so, should the commercial code enact rules with a view toward the effects of the transactions it governs? Does it already do this, or does it (and should it) not?

Part I explores the logic of these foundational questions. Part II then presents a specific context in which one particular form of secured transaction—the securitized mezzanine loan<sup>10</sup>—funds developments that contribute to one controversial environmental outcome: sprawl.<sup>11</sup>

Numerous scholars are looking critically at contemporary forms of financial transactions to better understand their distributive implications, capacity for wealth maximization, or tendencies to create moral hazard.<sup>12</sup> The purpose of this work is not to join the chorus of critics who call for regulation of financial transactions in light of recent market failures. Rather, it is to ask foundational questions about the relationship between the structure of certain types of financial transactions and the real-world applications of the capital they raise. In particular, the focus here is on environmental consequences of real-world applications of capital raised by securitized debt finance.<sup>13</sup> Suburban sprawl is an example of an environmental consequence of applications of capital raised with this type of financing.

Demonstrating a relationship between financing practices and environmental results raises core questions about the scope and

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<sup>10</sup> Securitized mezzanine lending has slowed down recently, but facilities and templates remain in place and the practice will continue. In fact, some commentators identify this transaction as a way to continue to maximize leverage in real estate development financing despite mortgage lenders' return to stricter loan-to-value requirements. See *infra* notes 107–12 and accompanying text. For a description of this transaction, see *infra* Part II.B.

<sup>11</sup> Scholars focused on land use policy have discussed sprawl from a variety of vantage points. The word “sprawl” is pejorative and its meaning is complex, but scholars have developed several working definitions that capture the kinds of car-dependent, high-carbon-footprint developments that threaten natural resources throughout the United States. See *infra* Part II.A.

<sup>12</sup> See, e.g., TODD J. ZYWICKI, *BANKRUPTCY LAW AND POLICY IN THE TWENTY-FIRST CENTURY* (forthcoming 2011); Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 *FORDHAM L. REV.* 101 (2007); Edward J. Janger, *The Death of Secured Lending*, 25 *CARDOZO L. REV.* 1759 (2004); Lynn M. LoPucki, *The Death of Liability*, 106 *YALE L.J.* 1 (1996); Steven L. Schwarcz, *Securitization Post-Enron*, 25 *CARDOZO L. REV.* 1539 (2004).

<sup>13</sup> “Securitized debt finance” refers to loans funded by the proceeds of issuances of securities that are collateralized with the same or similar loans.

structure of the private-law rules that comprise commercial finance law. These rules—primarily property and contract doctrines codified in the UCC and related statutes—create the commercial finance law system that provides the basis for practices like securitization.

The objective of this discussion is not to assign liability for environmental harm to secured lenders. It is to relate environmental consequences to the financing practices that shape commercial activity. Specifically, it is to relate securitized structured finance in real estate development to the phenomenon of suburban sprawl and its environmental impact.

The houses offered to consumers (who may acquire them with mortgage products) do not sprout from the ground. Developers build them with proceeds of secured loans that are very often funded by securitization facilities. This financing structure can be highly advantageous for builders, buyers, and financiers alike when it lowers costs of capital for development that provides new housing that meets buyers' needs. However, this approach to finance can just as readily be problematic. For example, securitized financing can fund the building of more homes at a faster pace than communities desire and the environment can withstand.<sup>14</sup>

The modes of finance that fund developers' projects facilitate developers' potential to build at rates that can outpace collective decisions regarding open-space preservation. Current modes of real estate finance permit developers to transfer much of the risk of loss surrounding new developments to financiers.<sup>15</sup> There is nothing inherently wrong with risk transfer; it is a concept at the root of financial transactions. Risk transfer becomes problematic when it creates moral hazards that result not just in transferring risk to a

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<sup>14</sup> Open-space land is a collective asset with important ecological functions. Some states have begun to quantify the ecological contributions of open spaces by assessing "ecosystem services." Ecosystem services are the services that natural systems, or undeveloped areas, contribute to the public welfare. Studies quantify the value of these services by calculating the replacement cost to the state of services like water filtration or carbon dioxide absorption that areas like estuaries or forests currently perform. See James Salzman, *Creating Markets for Ecosystem Services: Notes from the Field*, 80 N.Y.U. L. REV. 870, 897–99 (2005). Some states have commissioned reports to assess ecosystem services provided by the various natural resources in the state. See, e.g., ROBERT CONSTANZA ET AL., GUND INST. FOR ECOLOGICAL ECON., THE VALUE OF NEW JERSEY'S ECOSYSTEM SERVICES AND NATURAL CAPITAL (2006).

<sup>15</sup> See *infra* Part II.B.



financer for a price but also in costs to communities and the environment.<sup>16</sup>

When developers use certain common modes of secured debt financing to undertake new projects, they can transfer risk of the projects' failure to financiers and, ultimately, capital markets. This Article explores the implications of this reality for communities that want to control suburban sprawl.<sup>17</sup>

Others have made the connection between secured transactions and environmental consequences of the activities they fund. Many have recognized that: (1) environmental harm often results from the activities of project company subsidiaries—the assets of which are assigned to a secured lender, and the liabilities of which are separate from those of its corporate parent;<sup>18</sup> and (2) secured lenders exercise substantial control over debtors through loan covenants and monitoring.<sup>19</sup>

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<sup>16</sup> The relationship between transfer of risk and externalization of risk is complex. Parties transfer risk when assets are sold along with attendant risks; in theory the price will reflect the various risks associated with the assets. Risks are externalized when they are not priced into transactions, as when private parties create risks that are imposed on the public. Recent crashes and developments in the financial and housing markets have generated much public discourse on the subject of externalities of transactions like subprime mortgages and securitization. This discourse has engaged both risk transfer and its capacity to create moral hazard, and risk externalization—socialization of loss—that recent market practices have caused. Many contend that risk transfer through securitization leads to externalization of risk, and, ultimately, of loss, when the transferred assets fail. See, e.g., Engel & McCoy, *supra* note 12 (discussing effects of securitization on borrowers and on predatory lending practices); LoPucki, *supra* note 12 (arguing that secured lending and securitization enable externalization of costs onto certain classes of unsecured creditors).

<sup>17</sup> Some argue that new homes trending upward in size and outward across our countryside reflect consumer preferences. But the notion that consumer demand for housing as a commodity should drive land-use policy is problematic. Consumer preferences are complex. If a larger polity determines that open-space preservation is important, then the individual preferences of some consumers may not justify land use policies that produce irreversible consumption of open space.

<sup>18</sup> See *infra* Part I.A.

<sup>19</sup> Given these realities, scholars and lawmakers have argued for secured lender liability under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and for priority in advance of secured lenders for environmental claims. Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 U.S.C. §§ 9601–9675 (1986). Secured lenders themselves have acknowledged their role; many project financiers have adopted the Equator Principles. The Equator Principles are standards for secured lending that include a commitment to fund only projects that meet certain environmental criteria. EQUATOR PRINCIPLES ASS'N, THE EQUATOR PRINCIPLES: A FINANCIAL INDUSTRY BENCHMARK FOR DETERMINING, ASSESSING AND MANAGING SOCIAL & ENVIRONMENTAL RISK IN PROJECT FINANCING (2006), available

Part I moves beyond existing approaches to secured transactions and environmental impact to challenge the notion that the role of commercial finance law is to facilitate commercial transactions without regard for the transactions' environmental effects.<sup>20</sup>

After Part I discusses the connection between debt finance and environmental impact generally, Part II.A describes sprawl and the controversy surrounding environmental consequences of sprawling development. Part II puts the questions presented in Part I.B at play in the context of securitized mezzanine financing for developments that contribute to suburban sprawl. It seeks to demonstrate a relationship between contemporary commercial finance practices and land-use results that many find problematic. "Mezzanine financing" in this context refers to a secured transaction in which the lender takes a first-priority security interest in the membership interests of an entity (usually a limited liability company (LLC) that holds real estate for the purpose of development).<sup>21</sup> A mortgage lender typically holds

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at [http://www.equator-principles.com/resources/equator\\_principles](http://www.equator-principles.com/resources/equator_principles). Other major institutional lenders have adopted the Carbon Principles—commitments to enhanced diligence in financings of fossil fuel generation projects. See, e.g., Press Release, Bank of Am., Bank of America to Announce Adoption of the Carbon Principles at Natural Resources Defense Council's Tenth Annual Award Event (Apr. 1, 2008) (on file with author). A secured lender generally is not liable under CERCLA unless the lender controls activities on the site to such an extent that it is effectively the owner-operator of the business on the site. See *infra* Part I.A.

<sup>20</sup> A few scholars have argued that the very structure of UCC Article 9 encourages production without regard to ecology, and is therefore incompatible with environmental objectives. We can understand these arguments as secured-transactions-law-specific versions of arguments about environmental harm as a form of market failure more generally. See, e.g., Richard L. Barnes, *The U.C.C.'s Insidious Preference for Agronomy over Ecology in Farm Lending Decisions*, 64 U. COLO. L. REV. 457 (1993) (arguing that the unitary security interest and purchase money security interest (PMSI) have aggravated environmental destruction of American farmland); see also Heather Hughes, *Aesthetics of Commercial Law—Domestic and International Implications*, 67 LA. L. REV. 689, 716–23 (2007) (discussing a grid aesthetic in commercial law that puts consideration of environmental effects of commercial activity out of the purview of the UCC *ex ante*); Douglas A. Kysar, *Law, Environment, and Vision*, 97 NW. U. L. REV. 675, 676–77 (2003) (arguing that devices like carbon trading programs have failed to inspire deliberation over environmental goals because traditional cost-benefit analyses fail to account for absolute limits on environmental capacity); *infra* notes 72–85 and accompanying text.

<sup>21</sup> Note that the term "mezzanine finance" can describe other types of financings (such as unrated debt or convertible loans) in other industries. The consistent feature in all mezzanine financings is that they all involve debt that is senior to equity but functionally junior to some other debt. See Andrew R. Berman, *Risks and Realities of Mezzanine Loans*, 72 MO. L. REV. 993, 998 (2007). In the case of real estate mezzanine financing, the mezzanine lender's interest is a first-priority or senior interest in the mezzanine loan collateral, which is distinct in type from the mortgagee's or "senior" lender's collateral.

a first-priority lien on the real estate itself. The mezzanine lender holds a first-priority lien on the equity of a special-purpose company that holds the realty.

Mezzanine financing enables real estate developers to leverage their projects to a greater degree than is possible with mortgage financing. Leverage can have the effect of isolating developers from risk; developers can secure external financing for a project to maximize their gain if the project succeeds but to protect them from loss if it fails. Mezzanine lenders, in turn, can shift the risks associated with their mezzanine loan portfolios to investors by securitizing them.<sup>22</sup>

Mezzanine loans are one prominent form of real estate finance. The task here is to consider how we might link a given secured transaction to the environmental consequences of the activities it funds. Part II re-presents the questions explored in Part I in transaction-specific terms. For example, how can we say that mezzanine finance itself escalates certain types of development? And why focus on mezzanine finance as opposed to monetary policy or factors altogether apart from finance?

We could say that controversial environmental consequences of suburban sprawl are a function of mezzanine lending because securitized mezzanine lending enables real estate development to outpace the collective processes by which communities should make decisions about growth. Communities struggle with conflicting goals, such as the desire to have open space versus the desire to develop new

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The position of the mezzanine lender is distinct from that of a junior mortgage or second lien. *Id.*

<sup>22</sup> Mezzanine loans are certainly not the only transactions developers can use to raise capital. See *infra* notes 107–09 and accompanying text. They may use, for example, preferred equity financing or junior mortgages. UCC Article 9 treats the membership interests of an LLC assigned to secure a mezzanine loan like any other LLC membership interests. (They are general intangibles, unless the members, in the LLC operating agreement, designate their interests “investment property” within the meaning of Article 8 of the UCC.) U.C.C. §§ 8-103(c), 9-102(a)(42) (2005). Yet, LLCs that hold open-space land for development are, in an important sense, not like every other LLC. On the one hand, LLCs engage in countless business activities, all with environmental impact of one type or another. The LLC entity is just a tool that can be used for any kind of project. An instrumentalist aesthetic in commercial law informs this view. See Hughes, *supra* note 20, at 723–29. On the other hand, special-purpose LLCs formed for development of open space represent a use of this tool that we can link to controversial uses of land. Examining one typical form of real estate development finance could potentially enable reform of private actors’ capacities to do environmental harm in the first place.

neighborhoods to support the tax base and to attract new residents. These conflicting goals are not just tensions to resolve using cost-benefit concepts; they implicate deeper challenges surrounding the coexistence of attachment to nature and tolerance of destruction. For example, while communities, institutions, and individuals grapple with the value and meaning of open space, transactional structures designed to maximize access to capital for certain modes of building serve up the land for rapid consumption.<sup>23</sup>

The rules of commercial finance contemplate effects of transactions when presented as fairness or efficiency effects.<sup>24</sup> It is certainly possible to discuss controversial environmental effects of suburban sprawl in terms of efficiency<sup>25</sup> or in terms of fairness.<sup>26</sup> But

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<sup>23</sup> This Article is an example of what we might call “private environmental law”—scholarship that finds private ordering central to the concerns of environmental law. Cf. J. Kevin Healy et al., *Environmental Review and Climate Change Adaptation*, in *THE LAW OF GREEN BUILDINGS: REGULATORY AND LEGAL ISSUES IN DESIGN, CONSTRUCTION, OPERATIONS, AND FINANCING* 313, 330 (J. Cullen Howe & Michael B. Gerrard eds., 2010) (arguing for “real estate development to adapt to the new realities of the world with a changing climate”); Margaret Blair et al., *The Roles of Standardization, Certification and Assurance Services in Global Commerce*, 4 *COMP. RES. IN L. & POL. ECON.*, No. 3, 2008 at 1, 19, 34 (reflecting on the recent proliferation of social and environmental responsibility standards for global corporations and encouraging the use of “third-party assurance” which is a “market-based solution based on private ordering” to enforce environmental standards in global commerce); Jody Freeman & Daniel A. Farber, *Modular Environmental Regulation*, 54 *DUKE L.J.* 795, 803 (2005) (endorsing a modular conception of environmental regulation that “expands the universe of players that might be enlisted in decision making about resource conflict” to include private actors and stakeholders; Errol E. Meidinger, *Environmental Certification Programs and Environmental Law: Closer Than You May Think*, 31 *ENVTL. L. REP.* 10162, 10163, 10173 (2001) (advancing environmental certification programs, which “seek to verify for a broader public that the activities of certified [private] enterprises are environmentally appropriate,” arguing that such programs “are likely to become important engines of change in American environmental law,” and specifically naming property law as an area of law in which such programs will have an impact); Michael P. Vandenbergh, *The New Wal-Mart Effect: The Role of Private Contracting in Global Governance*, 54 *UCLA L. REV.* 913 (2007) (showing commercial industry leaders leverage contracting power to impose environmental practices on foreign suppliers); Michael P. Vandenbergh, *The Private Life of Public Law*, 105 *COLUM. L. REV.* 2029 (2005) (expanding the scope of the regulatory state to include private, “second-order” agreements between commercial parties, who assume public regulatory roles to better serve their private interests and avoid market and social sanctions).

<sup>24</sup> See *infra* text accompanying notes 62–63, 65–66.

<sup>25</sup> See, e.g., Kysar, *supra* note 20 (discussing ecological economics and how traditional economic methods do not account for absolute limits on capacities of the natural environment).

<sup>26</sup> For example, environmental impact concerns intergenerational fairness, such as expressed by the Iroquois practice of testing decisions for effects seven generations

to the extent that standardized forms of financial transactions fund recurring land uses that many find problematic, the terms and structures of the transactions themselves should be a subject of critical inquiry.

## I

### DEBT FINANCE AND ENVIRONMENTAL CONSEQUENCES

The relationship between debt finance and environmental impact is a function of two concepts that are foundational to commercial financing transactions: (1) secured lenders' monitoring and directive power, and (2) limited liability. The monitoring function of secured lenders can make them effective predictors and mitigators of environmental harm. At the same time, the common practice of limiting liability surrounding a project or venture funded by debt finance—by isolating liabilities to a special-purpose entity, the assets of which are assigned to lenders—can make lenders the most immediate financial risk bearers in a commercial undertaking.

Many scholars and practitioners have found that these two facets of secured lending create a nexus between secured lenders and debtors' environmental impact.<sup>27</sup> Few have taken the step of challenging the prevailing notion that effects of transactions are not the province of debt finance law.

Part I.A explains the roles of monitoring and limited liability in commercial debt finance. Part I.B then moves forward to question the pervasive idea that commercial finance law need not concern itself with the environmental effects of applications of capital raised with secured debt.

Commercial actors use the private-law rules governing secured debt—most notably UCC Article 9—to enter into transactions with a wide range of effects, some good and some bad on many different fronts—social, environmental, psychic, etc. Demonstrating the relationship between secured lenders and the environmental

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subsequent. Joagguisho (Oren Lyons), *Scanno*, 28 PACE ENVTL. L. REV. 334 (2010); see also Kristen A. Carpenter et al., *In Defense of Property*, 118 YALE L.J. 1022 (2009); Rebecca Tsosie, *Tribal Environmental Policy in an Era of Self-Determination: The Role of Ethics, Economics, and Traditional Ecological Knowledge*, 21 VT. L. REV. 225, 272–76 (1996).

<sup>27</sup> See *infra* Part I.A.

consequences of activities they fund requires grappling with several fundamental questions.

Part I.B states and discusses the following questions in turn: First, how can we say that secured transactions law, primarily UCC Article 9, itself escalates commercial activity and hence its environmental impact? Second, even if UCC Article 9 does escalate certain forms of commercial activity, why should the UCC get into the business of designing rules with a view toward the effects of the transactions it governs? By what logic are threats to the environment, for example, a UCC problem?

Environmental concerns are typically the province of regulation. In recent years, largely in response to climate change, the set of regulators and regulatory mechanisms has diversified beyond a centralized top-down approach.<sup>28</sup> Depending on one's perspective, to limit certain forms of development for environmental reasons by making changes to secured transactions law could be to "regulate" by means not traditionally associated with regulation. Different regulatory subjects enable different degrees and modes of regulation.

#### *A. Secured Lenders, Monitoring, and Limited Liability*

An extensive literature discusses the monitoring function of secured creditors.<sup>29</sup> Scholars have focused on monitoring costs in

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<sup>28</sup> For example, a majority of U.S. states enact climate change legislation, and numerous state and local governments and industry organizations have adopted rules and standards designed to improve environmental sustainability. See Heather Hughes, *Enabling Investment in Environmental Sustainability*, 85 IND. L.J. 597, 600–01 nn.19–20, 636 (2010); *U.S. States and Regions*, PEW CENTER ON GLOBAL CLIMATE CHANGE, <http://www.pewclimate.org/states-regions> (last visited Nov. 18, 2011) (providing a state-by-state survey of this legislation). Some scholars associate this proliferation of regulatory actors with the federal government's failure to respond to climate change during the Bush administration. See, e.g., Patrick Parenteau, *Lead, Follow, or Get out of the Way: The States Tackle Climate Change with Little Help from Washington*, 40 CONN. L. REV. 1453, 1471 (2008). Climate change legislation aside, numerous scholars have criticized the top-down, federal-government-driven approach to environmental regulation. For example, Todd Zywicki has argued that certain special interest groups benefit from the top-down regime, which permits rent seeking and division of gains among special interest players and discourages decentralized, market-based alternatives. See Todd J. Zywicki, *Environmental Externalities and Political Externalities: The Political Economy of Environmental Regulation and Reform*, 73 TUL. L. REV. 845 (1999).

<sup>29</sup> See, e.g., Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982); Ronald J. Mann, *Explaining the Pattern of Secured*

theories that set out to explain secured transactions.<sup>30</sup> Borrowing on a secured, as opposed to an unsecured, basis entails a variety of costs (including costs of monitoring).<sup>31</sup> Many discussions of the corresponding benefits of secured credit focus on how secured debt can reduce agency costs.<sup>32</sup> Secured creditors can monitor debtors and threaten foreclosure on assets if a debtor engages in risk-altering behavior, underinvests to maximize its own profits at the expense of a joint venturer, or threatens opportunistic default.<sup>33</sup>

For purposes of understanding how the law currently conceives of the relationship between secured lending and debtors' environmental impact, it is primarily important to understand that secured creditors have monitoring and directive power over debtors. Much of the scholarship referenced above concerns efficiencies and inefficiencies of secured credit. But regardless of whether secured credit induces efficiencies through monitoring, the fact that secured lending

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*Credit*, 110 HARV. L. REV. 625 (1997); Richard Squire, *The Case for Symmetry in Creditors' Rights*, 118 YALE L.J. 806 (2009).

<sup>30</sup> As Richard Squire notes, "Although several scholars have argued that the secured loan promotes creditor monitoring efficiencies, they have disagreed about *which* creditors it encourages to monitor." Squire, *supra* note 29, at 850 (summarizing and contesting prior monitoring theories); see also F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1396 (1986) (arguing that secured debt is efficient and that it, paradoxically, appears to increase monitoring costs); Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1150-51 (1979) (dismissing creditor monitoring in relation to costs of borrowing and stating that the existence of collateral is likely to reduce monitoring costs); Levmore, *supra* note 29, at 50-59 (arguing that secured credit induces efficient levels of monitoring because it addresses freeriding considerations); Mann, *supra* note 29, at 650-51 (investigating parties' motivations for using secured credit and discussing how collateral narrows the focus of a creditor's monitoring).

<sup>31</sup> These include transaction costs of taking and perfecting a security interest, costs of monitoring, and opportunity costs to the debtor. See Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 877 (1996).

<sup>32</sup> Other theories have proposed that secured credit enables companies to redistribute value away from non-adjusting and non-consenting creditors, enabling the debtor to obtain a lower interest rate while externalizing costs onto these unsecured parties. For a summary of this scholarship, see Hughes, *supra* note 20, at 712-14; Yair Listokin, *Is Secured Debt Used to Redistribute Value from Tort Claimants in Bankruptcy? An Empirical Analysis*, 57 DUKE L.J. 1037 (2008) (finding that firms with high tort risk do not issue more secured debt than other firms, negating the redistribution theory of secured credit). See also Squire, *supra* note 29, at 838-42 (stating that debtor opportunism in shifting costs to non-adjusting creditors is the only explanation for the persistence of asymmetrical asset partitioning).

<sup>33</sup> See Listokin, *supra* note 32, at 1047.

agreements enable monitoring of debtors puts secured lenders in a position to anticipate, and potentially control, companies' environmental impacts.

Secured creditors monitor debtors in a number of ways. They require debtors to report any events or actions that affect the value of their collateral or a debtor's ability to repay a loan. They search lien records. They require debtors to provide statements of compliance with all loan covenants as a condition to disbursement of funds. They require debtors to submit periodic financial statements or other reports evidencing the financial condition of the debtor. Loan covenants typically include requirements to report any potential liabilities (including, of course, environmental liabilities).

Loan covenants and monitoring activities are not merely about reporting the status of the debtor. They are also about enabling secured lenders to direct a debtor's behavior in situations where a debtor's activities or external circumstances are jeopardizing a secured lender's expected return on its investment. Because secured transactions typically create significant monitoring power with respect to debtors' activities and assets, they put secured lenders in a strong position to identify and deter bad behavior.

The concept of debtor misbehavior typically refers to behavior that alters a lender's risk, such as applying proceeds of a loan in ways the lender did not anticipate or engaging in misrepresentation or even fraud. If a debtor creates environmental costs, this could indicate debtor misbehavior to the extent that these costs result from unanticipated actions or jeopardize the debtor's ability to pay or the value of assigned assets.

Many secured lenders use loan covenants to ensure that debtors are not creating environmental costs in excess of what the parties expect. For example, if a company seeks to own and operate a manufacturing facility funded with secured debt, the facility has likely been subject to an environmental impact assessment. If the debtor creates risk of environmental liability in excess of what the assessment anticipates, this will likely constitute an event of default under a loan and security agreement. The debtor would be obligated by contract to inform its secured lender of the potential liability.

Nothing obligates a secured lender to respond or to remedy the situation when a debtor causes this type of event of default. The questions of whether to call the loan, whether to become involved with the debtor's affairs, or whether to request more detailed information are all entirely within the lender's discretion.



Given the degrees of monitoring power and control over debtors' behaviors that secured lenders can have, the law contemplates secured party liability for environmental costs in certain situations. Specifically, a lender can be liable if its debtor causes environmental damage that creates liability under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA),<sup>34</sup> during a time when the secured lender exercised a degree of control sufficient to make it an "owner or operator" within the meaning of the statute.<sup>35</sup> The idea is that when a debtor pollutes, if that debtor's secured lender was directing the debtor's activities to a sufficient extent, then liability for clean up extends to the secured lender.<sup>36</sup>

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<sup>34</sup> CERCLA was enacted originally in 1980. 42 U.S.C. §§ 9601-9675 (2006). The Superfund Amendments and Reauthorization Act (SARA) amended CERCLA on October 17, 1986. Superfund Amendments and Reauthorization Act of 1986, Pub. L. No. 99-499, 100 Stat. 1613. The Small Business Liability Relief and Brownfields Revitalization Act (Brownfields Amendments) amended it further in 2002. Small Business Liability Relief and Brownfields Revitalization Act, Pub. L. No. 107-118, 115 Stat. 2356 (2002).

<sup>35</sup> 42 U.S.C. § 9607(a)(1)-(4).

<sup>36</sup> In addition to liability under CERCLA, secured lenders may also be liable for hazardous substance cleanup under a state "Superfund" statute. Numerous states have enacted such statutes, some of which create a lien in favor of the state that takes priority over security interests. See, e.g., CONN. GEN. STAT. ANN. §§ 22a-451 to 452c (West 2011); MASS. GEN. LAWS ANN. ch. 21E, § 13 (West 2011); N.H. REV. STAT. ANN. §§ 147-B:10, 147-B:10-b, (2011); N.J. STAT. ANN. § 58:10-23.11f(f) (West 2011). Also, academics have proposed granting to environmental claimants priority under UCC Article 9. Under these proposals, if a debtor becomes insolvent, environmental claims would be satisfied out of the debtor's assets before secured lenders' claims are satisfied. See, e.g., Kathryn R. Heidt, *Cleaning up Your Act: Efficiency Considerations in the Battle for the Debtor's Assets in Toxic Waste Bankruptcies*, 40 RUTGERS L. REV. 819, 822 (1988); Kathryn R. Heidt, *Corrective Justice from Aristotle to Second Order Liability: Who Should Pay When the Culpable Cannot?*, 47 WASH. & LEE L. REV. 347, 348 (1990); LoPucki, *supra* note 12 (arguing for priority for tort claims generally). Some state Superfund statutes enact "super liens" that give the government's claim for cleanup costs priority over secured lenders. Where these liens do arise, they can subordinate a secured lender's claim to the government's claim. These liens arise only in the specific context of state Superfund cleanup of contaminated sites. Proposals that legal scholars have made for tort claim priority or environmental claim priority, in contrast, could apply across contexts involving tort or environmental liability. See, e.g., CONN. GEN. STAT. ANN. § 22a-452a; LA. REV. STAT. ANN. § 30:2281 (West 2011); ME. REV. STAT. ANN. tit. 38, § 1371 (West 2011); MASS. GEN. LAWS ANN. ch. 21E, § 13; MICH. COMP. LAWS ANN. § 324.20138 (West 2011); N.H. REV. STAT. ANN. § 147-B:10-b (Supp. 2011); N.J. STAT. ANN. § 58-10-23.11f(f) (West 2011); WIS. STAT. ANN. § 292.81(3), (4) (West 2011). Jonathan Remy Nash reports: "[I]n the late 1980s the trend toward proliferation of superlien statutes subsided. . . . Some states have repealed their superlien statutes, and only one state has enacted a superlien statute since the end of 1990." Jonathan Remy Nash, *Environmental Superliens and the Problem of Mortgage-Backed Securitization*, 59 WASH. & LEE L. REV. 127, 131-32 (2002).

CERCLA created a "Superfund" to enable government cleanup of contaminated sites and then recover costs from the parties responsible for the pollution.<sup>37</sup> CERCLA designates as parties responsible present and past owners or operators of contaminated sites.<sup>38</sup>

The statute reflects the prevailing notion that lenders are not responsible for effects of debtors' actions. It excludes from the scope of owner or operator "a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility."<sup>39</sup> This provision creates, in essence, a security-interest-holder exemption.

Yet, the statute does not simply exempt secured lenders from liability altogether. Rather, it requires distinction between situations in which secured lenders merely hold indicia of ownership versus situations in which secured lenders participate in management to an extent sufficient to create liability. CERCLA liability may extend to secured lenders in two general ways. A secured lender can (1) become involved in the management of a debtor's affairs such that it "participates in the management of a vessel or facility" to an extent

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<sup>37</sup> CERCLA creates strict liability and joint-and-several liability. The EPA may recover costs from one responsible party, leaving that party to seek contributions from others. See generally *United States v. Fleet Factors Corp.*, 901 F.2d 1550, 1557-58 (11th Cir. 1990), (finding a secured creditor subject to CERCLA liability) *superseded by statute*, 42 U.S.C. § 9601(F)(i)(II), as recognized in *Monarch Tile, Inc. v. City of Florence*, 212 F.3d 1219 (2000); *Guidice v. BFG Electroplating & Mfg. Co.*, 732 F. Supp. 556, 560-62 (W.D. Pa. 1989) (finding a bank, which is a secured creditor of a polluted site, could be liable under CERCLA); Bruce P. Howard & Melissa K. Gerard, *Lender Liability Under CERCLA: Sorting out the Mixed Signals*, 64 S. CAL. L. REV. 1187, 1188 (1991) (explaining how, until recently, federal district courts generally interpreted CERCLA to exempt a lender from liability unless it was involved in the day-to-day operations of the facility); Susan M. King, *Lenders' Liability for Cleanup Costs*, 18 ENVTL. L. 241, 266-74 (1988) (discussing legal risks to lenders under CERCLA); Roslyn Tom, Note, *Interpreting the Meaning of Lender Management Participation Under Section 101(20)(A) of CERCLA*, 98 YALE L.J. 925, 943-44 (1989) (stating reasons why the liability of lenders should be triggered by activities suggesting ownership).

<sup>38</sup> 42 U.S.C. § 9607(a)(1)-(4). The statute defines "owner or operator" as a range of parties, including present and past owners, generators of hazardous substances sent to sites, and certain transporters of such substances. *Id.* § 9601(20)(A). CERCLA imposes liability on four types of responsible parties: current owners or operators of a vessel or facility; those who owned or operated a facility at the time hazardous waste was disposed of or deposited; persons who arranged by contract to have hazardous substances transported to, disposed of, stored, or treated at a facility owned or operated by someone else; and transporters. *Id.* § 9607(a)(1)-(4).

<sup>39</sup> *Id.* § 9601(20)(A).

that removes the lender from the so-called security-interest exemption, or (2) foreclose and become the owner of a site (rather than a security interest holder with mere “indicia of ownership”).<sup>40</sup> The scope of situations in which lenders are liable under CERCLA has not always been clear,<sup>41</sup> though amendments to the statute, passed in 1996<sup>42</sup> and 2002,<sup>43</sup> have alleviated much uncertainty.<sup>44</sup>

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<sup>40</sup> See ENVTL. PROT. AGENCY, CERCLA, BROWNFIELDS, AND LENDER LIABILITY, (2007), available at [www.epa.gov/brownfields/aai/lenders\\_factsheet.pdf](http://www.epa.gov/brownfields/aai/lenders_factsheet.pdf).

<sup>41</sup> Early cases disagreed on whether to distinguish a secured lender's exercise of financial controls from participation in operational affairs. In 1990, *United States v. Fleet Factors Corp.* held that a secured lender could be liable as an operator “by participating in the financial management of a facility to a degree indicating a capacity to influence the corporation's treatment of hazardous wastes. It is not necessary for the secured creditor actually to involve itself in the day-to-day operations of the facility in order to be liable . . . .” *Fleet Factors Corp.*, 901 F.2d at 1557. The *Fleet Factors* approach was not universally adopted. In another 1990 case, *In re Bergsoe Metal Corp.*, the Ninth Circuit held that “there must be *some* actual management of the facility before a secured creditor will fall outside the [security interest] exception [in section 101(A)(20)].” *Hill v. E. Asiatic Co. (In re Bergsoe Metal Corp.)*, 910 F.2d 668, 672 (9th Cir. 1990). The EPA responded to *Fleet Factors* by promulgating rules to negate the case, but the D.C. Circuit Court of Appeals then ruled in *Kelley v. EPA* that the EPA lacked the authority under CERCLA to make substantive rules limiting lenders' liability for costs of hazardous-waste cleanups. See *Kelley v. EPA*, 25 F.3d 1088, 1092 (D.C. Cir. 1994).

<sup>42</sup> The Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996, Pub. L. No. 104-208, 110 Stat. 3009 (codified at 42 U.S.C. §§ 9601, 9607), amended CERCLA to establish that “participation in management” does not include activities like property inspection, giving financial advice, or requiring a debtor to respond to contamination. A secured lender participates in management of a debtor for CERCLA liability purposes, according to EPA guidelines, if it “exercises decision-making control over a property's environmental compliance, or exercises control at a level similar to that enjoyed by a manager of the facility or property.” ENVTL. PROT. AGENCY, *supra* note 40.

With respect to foreclosure, the 1996 amendments state that foreclosing on a property does not make a secured lender an “owner or operator” under CERCLA, provided that the bank takes steps to sell the property “at the earliest practicable, commercially reasonable time, on commercially reasonable terms.” *Id.* A secured creditor that has foreclosed may maintain business activities and wind down operations on a site without becoming an “owner or operator” under CERCLA, as long as the secured lender lists the property for sale at the earliest practicable, commercially reasonable time. *Id.*

<sup>43</sup> In 2002, Congress passed the Brownfields Amendments, further clarifying the range of situations in which secured creditors will be liable by creating new landowner liability protection (for owners who purchase property after it has been contaminated by someone else). Small Business Liability Relief and Brownfields Revitalization Act, Pub. L. No. 107-118, 115 Stat. 2356 (2002).

<sup>44</sup> The way in which CERCLA implicates secured lenders creates some interesting tensions. The issue is, on the one hand, respecting banks' positions as outside financiers who make investments and provide funds but are not responsible for debtors' actions, while at the same time holding banks liable in situations in which they were in control of a contaminating facility such that they are appropriate bearers of liability.

If secured lenders were excluded categorically from CERCLA liability, it could create moral hazard. Secured lenders and debtors could deliberately effectuate conveyance of a first-priority interest in the debtor's assets, knowing that the debtor may pollute for profit and externalize cleanup costs to the government.<sup>45</sup> Yet, if secured lenders were categorically included in CERCLA's definition of owners and operators, then lenders would have incentive to call defaults in situations in which they might otherwise use their power to aid debtors in avoiding or mitigating costs.

The relevance of CERCLA here is simply to show that the law already acknowledges secured lenders' capacity for monitoring and directing debtors' activities. It assigns liability for environmental harm to secured parties in certain circumstances as a result.

While a secured party can have monitoring power and control over a debtor in any secured transaction, secured parties commonly establish these powers in transactions in which the parties use a limited-liability special-purpose or project entity to protect a company from risks associated with a given venture. In these very common transactions, we can conceive of the secured lender as the party with the most immediate financial stake in the debtor's activities.

The concept of limited liability is crucial to contemporary commercial financing transactions. "Structured finance" refers to transactions in which a company seeking to raise capital from lenders transfers assets to a limited liability entity such as a corporation or an LLC. The lenders then assess the credit of the entity apart from that of its parent or owners. In transactions to fund projects, new facilities, new developments, or the like, lenders fund the activity undertaken by the special entity, taking a security interest in its assets (and not necessarily in any assets of the parent). Of course a transaction may create recourse to assets of a parent company, equity holder or other party, but the model of lending against the value of assets held by a limited liability entity with recourse only to such assets is commonplace.

When a lender has a security interest in all assets of a limited liability entity, it becomes an immediate bearer of financial risk. The

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<sup>45</sup> CERCLA provides that a federal government lien imposed by the statute "shall be subject to the rights of any purchaser, holder of a security interest, or judgment lien creditor whose interest is perfected under applicable State law before notice of the lien has been filed." 42 U.S.C. § 9607(1)(3).

parent or owners have not expended their own funds to undertake the project—the secured lender has. The secured lender should be first to be repaid. Failure of a project that causes default on a loan directly affects secured lenders; they cannot go after other parties or assets to recoup their investment (in a limited-recourse transaction).

Securitization transactions rely on limited-liability special-purpose entities to separate assets from liabilities with the goal of enhancing credit. A company seeking to securitize rights to payment, for example, sells these rights to a separate special-purpose entity. These assets are thereby separated from any liabilities of the company as a going concern. The separate special-purpose entity then issues debt instruments secured by the rights to payment. The company can raise more capital against the value of the assets in the hands of the limited liability entity than it could if the assets were on its own books, because the special-purpose entity has no liabilities to discount from the assets' value.

The use of limited-liability special-purpose entities to isolate assets is ubiquitous in commercial finance. For purposes of this discussion, the relevance of limited liability structures in finance is that they allow companies to shift the risk associated with any given venture to the secured lenders. Risks are isolated to a project entity, and the cash for that entity's activities comes from secured lenders. Owners of the entity take any upside, such as profits in excess of the loan obligations. Owners minimize exposure to losses by seeking lenders to fund the project.

Lenders, of course, enjoy the upside of their expected return on investment—repayment with interest—assuming there is not a default. If a debtor does default, lenders can foreclose on assets. Lenders also protect themselves against risk by creating diversified portfolios of loans that they can sell to participating investors, either with securitization transactions or through syndication.

Companies can transfer risks associated with any given project to secured lenders, and secured lenders are not liable for effects of applications of capital that they provide. If a project entity<sup>46</sup> causes environmental harm, its parent company or owners can be isolated

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<sup>46</sup> Project entities are limited liability entities formed for the sole purpose of developing, owning and operating a particular project. *See, e.g.*, BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (2005), available at <http://www.bis.org/publ/bcbs118.pdf>.

from liability; lenders funded the activities that resulted in harm, but they are only liable in the limited situations involving hazardous waste cleanup, as discussed above. Because of this reality, institutional lenders have taken it upon themselves to articulate responsibility for avoiding environmental harm that could result from projects they fund.

A long list of project financiers has adopted the Equator Principles—standards for secured lending that include a commitment to fund only projects that meet certain environmental criteria.<sup>47</sup> A separate list of major institutional lenders has adopted the Carbon Principles—commitments to undertake heightened due diligence regarding environmental impact when financing fossil fuel generation projects.<sup>48</sup> The Equator Principles apply in the context of transnational project finance.<sup>49</sup> The Carbon Principles apply, so far, only to North American power generation projects.<sup>50</sup>

It is unknown, at the moment, what the effects of the Equator Principles and the Carbon Principles will be. Though the Equator Principles require subscribing banks to include in project loan documentation covenants under which the borrower agrees to maintain compliance with articulated environmental (and other) standards, there is no obligation on the part of the lender to call an event of default if such covenant were breached.<sup>51</sup> There are many difficulties in enforcing nonfinancial defaults, like default in compliance with an environmental standard that does not create potential legal liability. With respect to the Carbon Principles, banks may just be trying to minimize costs surrounding debtors' compliance with anticipated regulation, or they may be attempting to influence

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<sup>47</sup> EQUATOR PRINCIPLES ASS'N, *supra* note 19. Numerous major U.S. and foreign lenders such as Bank of America, ABN AMRO, and Wells Fargo are Equator Principles financial institutions.

<sup>48</sup> See THE CARBON PRINCIPLES: FOSSIL FUEL GENERATION FINANCING ENHANCED ENVIRONMENTAL DILIGENCE PROCESS, *available at* [www.carbonprinciples.org](http://www.carbonprinciples.org) (the principles were developed by Citi, JPMorgan Chase, and Morgan Stanley with help from leading power companies and environmental organizations); *see, e.g.*, Bank of Am., *supra* note 19.

<sup>49</sup> See EQUATOR PRINCIPLES ASS'N, *supra* note 19.

<sup>50</sup> The subscribing banks "decided to focus on power generation in North America because of attention to this market by legislators and other stakeholders," but may extend the principles to other markets. CARBON PRINCIPLES Q & A, at Questions 11–12, *available at* <http://www.carbonprinciples.org/documents/Carbon%20Principles%20QA.pdf>.

<sup>51</sup> See EQUATOR PRINCIPLES ASS'N, *supra* note 19.

the content of that regulation by proactively establishing the extent of diligence they are willing to undertake.<sup>52</sup>

The relevance of the Equator and the Carbon Principles here is simply to show that secured parties themselves recognize that in transactional contexts in which the debtor is an entity formed to isolate liability surrounding certain activities, secured parties can be the primary parties taking financial risk and controlling for things like environmental impact.

Again, the law here reflects the notion that effects of project financing transactions are not relevant to commercial finance law itself. Secured lenders are electing to acknowledge their relationship to the environmental impact of debtors' activities with the Equator and the Carbon Principles. Nothing in the law obligates or enforces this acknowledgement.

The purpose here is not to argue for assignment of liability for environmental harm to secured lenders. In this Part, the goal is simply to understand the current relationship between lenders and environmental costs.

The remainder of this Part shifts focus to challenge the notion that commercial finance law should facilitate transactions without regard for transactions' environmental effects. This is not the same as challenging the extent to which secured lenders are isolated from liability for environmental harm caused by debtors. The inquiry here is not about whether to extend liability to secured lenders but whether the private law rules that constitute commercial finance law could themselves contemplate transactions' effects.

### *B. What Is a Debt Finance Law Issue, and What Is Not?*

Lawmakers tend to conceive of environmental issues in terms of environmental regulation and not in terms of commercial law. The task here is to explore and to challenge the logic of this separation of environmental concerns from commercial finance concerns.

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<sup>52</sup> A statement from subscribing banks entitled "Carbon Principles Q & A" reports: "We believe it is important to provide a framework for clients and financiers in this interim period while legislation is being crafted and that the experience derived from the Principles could also help inform the development of new and revised policy." CARBON PRINCIPLES Q & A, *supra* note 50, at Question 8. The banks believe that fossil fuel generation plants will be subject to more onerous legislation in the near future. Objectives of the Carbon Principles may include limiting the extent of this reform by creating and implementing standards in advance that are acceptable to the industry.

This logic is steeped in the notion that commercial law is a tool that can be used for a range of ends.<sup>53</sup> It does not itself increase or decrease the number of transactions, nor does it affect whether the proceeds of any given transaction are applied to alleviate or to aggravate environmental harm. In order to demonstrate, ultimately, a relationship between contemporary financing practices in real estate and a controversial outcome like suburban sprawl, it is necessary to first ask foundational questions about the scope of commercial law itself.

The commercial finance law primarily discussed here is UCC Article 9, governing extensions of credit secured by personal property. Many commercial finance transactions purport to effectuate a sale, such as in the context of sale-leaseback transactions for the financing of equipment. Securitization transactions involve two steps: (1) a sale of assets to the special-purpose entity, and (2) a simultaneous assignment by that entity of a security interest in the assets to investors. Though these kinds of transactions are not simple secured loans, they nonetheless implicate Article 9. In the context of securitization, the special-purpose entity typically issues secured debt instruments.<sup>54</sup> In the context of sale-leaseback transactions, the buyer/lessor typically complies with the Article 9 requirements for creation and perfection of a security interest. Depending on the economic substance of a particular transaction, if the seller/lessee were to become insolvent, a court could find the transaction to be a secured loan governed by Article 9 (as opposed to a sale and lease).<sup>55</sup>

Also, because UCC Article 9 concerns loans secured by personal property (not realty), many do not realize its significance in the context of real estate finance. Developers very frequently form special-purpose or project entities to hold title to real estate. They then raise capital to develop the real estate by assigning security interests in the equity of the project entity—an assignment governed

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<sup>53</sup> See Hughes, *supra* note 20 (discussing the law-as-tool metaphor in terms of an instrumentalist aesthetic in commercial law); Annelise Riles, *A New Agenda for the Cultural Study of Law: Taking on the Technicalities*, 53 *BUFF. L. REV.* 973 (2005) (discussing the metaphor of law as a tool, and aesthetic practices, in the context of conflicts-of-law doctrine).

<sup>54</sup> Also, depending on the level of recourse in the sales contract between the special-purpose entity and the originator, that sales contract could in some cases be characterized as a secured loan. See generally JAMES J. WHITE, *SECURED TRANSACTIONS: TEACHING MATERIALS*, 282–303 (3d ed. 2006).

<sup>55</sup> See *id.* at 46–67.



by Article 9. This is true even though the entity is a shell that has no assets or function other than holding title to land. Article 9 governs the real estate mezzanine loans discussed in Part II.B.

*1. How Can We Say that UCC Article 9 Itself Escalates Commercial Activity?*

On the one hand, companies set out to undertake whatever projects and activities further their goals. If secured debt financing were not available to fund these undertakings, then, presumably, some other type of financing or source of capital would be.

On the other hand, the fact that much commercial activity, as we know it, could exist without Article 9 does not negate the facilitating role that Article 9 currently plays for many commercial undertakings. Article 9 provides a set of rules that make certain forms of secured lending expeditious. To claim that it does not, then, escalate the number (and therefore the effects) of the transactions it governs would be to deny Article 9's own objectives and success.

UCC Article 9 decreases transaction costs by setting out uniform rules for extensions of credit secured by personal property. Decreasing transaction costs is not necessarily linked to increasing the volume of commercial activity. Yet, at the same time, escalation of certain types of commercial activity is widely associated with the enactment of Article 9. Homer Kripke<sup>56</sup> asserts that "the legal structure of secured credit developed to make possible mass production and the distribution of goods."<sup>57</sup> It would be inconsistent to declare that secured transactions law makes mass production possible, while at the same time deny that these rules escalate commercial activity.

Commentators who doubt that secured transactions rules themselves escalate commercial activity may disagree with Kripke. But if one recognizes Article 9's facilitating effect on secured debt financing, then it would be inconsistent to at the same time maintain that this law does not, to some extent, escalate commercial activity.

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<sup>56</sup> Kripke was influential in the drafting of Article 9; he served as a member of the Permanent Editorial Board for UCC Article 9. See Allen R. Kamp, *Downtown Code: A History of the Uniform Commercial Code 1949-1954*, 49 BUFF. L. REV. 359 (2001); Homer Kripke, *The Principles Underlying the Drafting of the Uniform Commercial Code*, 1962 U. ILL. L.F. 321 (1962).

<sup>57</sup> Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929, 931 n.14 (1985).

2. *Even if UCC Article 9 Does Escalate Certain Forms of Commercial Activity, Why Should Article 9 Contemplate Effects of the Transactions It Governs?*

Well, in a sense, it already does. Practitioners and commentators tend to regard Article 9 as a set of technical rules to facilitate secured lending without regard for effects of any given transaction, positive or negative. But the UCC does contain numerous provisions aimed at avoiding or producing certain effects in the contexts of particular types of deals.<sup>58</sup> The Code was drafted with certain effects in mind, such as decreases in transaction costs or increases in interstate transactions (in response to uniformity).

The question, then, is whether there is some essential difference between the kinds of effects the UCC contemplates and, for example, environmental effects of the transactions it governs. One difference, perhaps, is that the effects the UCC contemplates concern, primarily, effectuating transactions themselves. The transactions' effects, we might say, are another story. Aside from a generalized commitment to the idea that growth is good, the effects the UCC deliberately generates are primarily effects *on* commercial transactions, not effects *of* commercial transactions.

But this distinction between effects on transactions and effects of transactions is not necessarily a viable one. Reducing transaction costs is not a neutral objective. Scholars and lawmakers have vigorously debated whether UCC Article 9 should be reformed in light of certain distributive consequences/effects of transactions governed by its full-priority floating lien rules.<sup>59</sup>

Article 9 lowers costs of secured transactions by enabling lenders to take a security interest in a wide range of assets with one conveyance. This security interest is "full priority," meaning that the secured lender can recover the full value of its interest if the debtor defaults, before other creditors recover at all. If the security interest covers after-acquired collateral (as Article 9 permits), this security interest is a "floating lien,"<sup>60</sup> meaning that the lender's lien attaches

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<sup>58</sup> See *infra* text accompanying notes 67–70.

<sup>59</sup> See *infra* notes 62–65 and accompanying text.

<sup>60</sup> "Floating lien" is a shorthand, not a statutory, term for a security interest that attaches to after-acquired collateral and for which the Code dates priority for future advances by the lender back to the date the lender first filed a UCC-1 financing statement or perfected its interest. See U.C.C. §§ 9-204 to -205, -323 (2005).

automatically to assets acquired after closing of the transaction. Priority of the lender's interest in after-acquired collateral dates back to the original filing the lender made in the UCC lien registry to give notice of its interest<sup>61</sup>—in UCC terms, to perfect its interest to establish priority.

Scholars have argued that the effects of transactions governed by these rules are both unfair and inefficient because they disadvantage non-adjusting creditors. Non-adjusting creditors are unsecured creditors that lack the opportunity to adjust their rate of return in response to the risk presented by an Article 9 secured creditor. Typical non-adjusting creditors include tort claimants, employees, and retirees. In terms of efficiency, scholars have contended that Article 9 artificially depresses the interest rates lenders charge.<sup>62</sup> In terms of fairness, scholars have questioned whether Article 9 creditors ought to recover the full value of their investments in advance of any recovery by unsecured creditors.<sup>63</sup>

Lawmakers have not revised Article 9 in response to these arguments;<sup>64</sup> the full priority structure prevails. What is interesting

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<sup>61</sup> *Id.*

<sup>62</sup> See Squire, *supra* note 29, at 844–67; cf. Lucian Arye Bebchuck & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics*, 82 CORNELL L. REV. 1279, 1290 (1997) (discussing how costs of full priority can result in inefficient contracting between borrowers and lenders); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1899 (1994) (discussing the positions of non-adjusting creditors). But see Listokin, *supra* note 32 (examining the redistribution theory of secured credit with empirical assessment of the prevalence of secured debt among “high-tort” firms); Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425 (1997) (arguing that secured credit creates value for unsecured creditors).

<sup>63</sup> See Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 615–18 (1981); LoPucki, *supra* note 12; Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373 (1997).

<sup>64</sup> Neither has the bankruptcy code, despite proposals made by Senator Richard J. Durbin (D-Ill.) and Representative William D. Delahunt (D-Mass.) during the bankruptcy reform process in 2002. See Employee Abuse Prevention Act of 2002, S. 2798, 107th Cong. (2002); H.R. 5221, 107th Cong. (2002). This bill would have enabled a bankruptcy trustee to include assets assigned to a perfected secured creditor in the bankruptcy estate under certain circumstances. It was presented as a way to protect workers and retirees from corporate misconduct. See Steven L. Harris & Charles W. Mooney, Jr., *The Unfortunate Life and Merciful Death of the Avoidance Powers Under Section 103 of the Durbin-Delahunt Bill: What Were They Thinking?*, 25 CARDOZO L. REV. 1829, 1829 n.2 (2004). The Durbin-Delahunt bill was criticized by organizations such as the National Conference of Commissioners on Uniform State Laws (NCCUSL), the Bond Market Association, and the Depository Trust and Clearing Corporation, and the Options Clearing

for purposes of this work is that opponents of these arguments about Article 9 and non-adjusting creditors do not argue that the role of the UCC is to reduce transaction costs without regard to its effects. The idea that bad effects of transactions are grounds for reforming the commercial law rules seems uncontroversial in the context of the secured transactions literature on this issue. Opponents take issue with the conclusion that secured transactions, per current Article 9 rules, are actually either inefficient or unfair.<sup>65</sup> The debate is not, on the one hand, arguments for reform in light of effects of secured transactions and, on the other hand, arguments against reform on ground that effects are not the province of the UCC. Rather, the debate is between scholars who maintain that Article 9 rules enable transactions that produce unfair and inefficient results and scholars who assert that these transactions do not produce unfair or inefficient results—or, at least, that the effects they do produce are extremely valuable and would be jeopardized by reform. This recent debate over effects of full-priority secured transactions highlights the continuity of questions about the effects of rules on transactions and the effects of transactions themselves.<sup>66</sup>

One more point is in order here about the distinction between UCC rules designed to produce effects on transactions—such as lowering transaction costs—versus rules geared toward effects of transactions—the real-world consequences of transactions. The UCC does not simply lower transaction costs across the board without regard for the effects of the transactions it is making less costly. The UCC privileges some kinds of transactions over others because the effects of some transactions are, apparently, more desirable than others.

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Corporation. *Id.* at 1831 (arguing that the Durbin-Delahunt bill was much more expansive in its attempt to avoid the interests of secured creditors in bankruptcy than the bill's sponsors had indicated). Its sponsors withdrew the bill in early September 2002. *Id.*

<sup>65</sup> See David Gray Carlson, *On the Efficiency of Secured Lending*, 80 VA. L. REV. 2179, 2182 (1994) (arguing that ordinary price theory shows that secured lending is rational); Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2024–25 (1994) (replying to fairness concerns by arguing that security interests are a form of property interest, alienable despite effects on third parties); Schwarcz, *supra* note 62 (on the efficiency of secured lending).

<sup>66</sup> Part II will delve into more detail regarding the relationship between a particular type of real estate development finance and the effects of the projects it funds.

The Code expressly privileges, for example, financing secured by rights to payment over contracts in which parties agree to prohibitions on assignment. The result is reduced transaction costs for deals like receivables securitization at the expense of fidelity to contractual obligations to account debtors.<sup>67</sup>

UCC section 9-408 provides that provisions in promissory notes, health-care-insurance receivables, or general intangibles are ineffective to the extent that they “would impair the creation, attachment, or perfection of a security interest”<sup>68</sup> in such assets or provide that assignment of a security interest in these assets may give rise to default or breach.<sup>69</sup> Section 9-408 alters the effects of a contractual anti-assignment provision. Article 9 includes this statutory overriding of anti-assignment clauses in order to encourage certain modes of financing.<sup>70</sup> Under secured transactions law, this kind of contract provision cannot prevent creation of a valid security interest and is ineffective to create a contractual event of default or breach. Because of section 9-408, companies can assign pools of rights to payment to lenders or to special-purpose vehicles for purposes of securitization without creating any worry for investors over whether the underlying contracts require consent to such assignment. Increasing access to capital by facilitating securitization is an effect of section 9-408 that the Code finds more important than the potential effects of this section on account debtors.<sup>71</sup>

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<sup>67</sup> There is a twist to UCC section 9-408 in that later creditors can take effective security interests, but cannot enforce their interests to the detriment of the other party to the contract that prohibited assignment. U.C.C. § 9-408 (2005). If a debtor is party to an agreement that restricts assignment, and the debtor assigns an interest in the agreement anyway, the secured creditor cannot enforce its interests to the detriment of the other party to the agreement. But the secured creditor will have a superior position at liquidation. It can wait for disposition of assets if the debtor cannot pay and it will prevail.

<sup>68</sup> *Id.* (a)(1).

<sup>69</sup> *Id.* (a)(2).

<sup>70</sup> *See id.* cmt. 2.

<sup>71</sup> Note that this feature of U.S. commercial law has been a subject of debate in rule-of-law projects abroad. *See, e.g.,* Bruce A. Markell, *A View from the Field: Some Observations on the Effect of International Commercial Law Reform Efforts on the Rule of Law*, 6 IND. J. GLOBAL LEGAL STUD. 497 (1999). The laws of many foreign jurisdictions do not permit assignment of receivables containing anti-assignment clauses. These jurisdictions often require notice to the account debtor when the account is assigned. United Nations Commission on International Trade Law’s (UNCITRAL) Convention on Assignment of Receivables overrides these local law provisions in nations that adopt it, but this Convention has not received wide acceptance. *See* United Nations Convention on the Assignment of Receivables in International Trade, G.A. Res., 56/81, U.N. GAOR, 56th

### 3. *By What Logic Is Environmental Impact a UCC Issue?*

Environmental harm does not result from one cause or one actor. UCC Article 9 does not “cause” environmental results any more than failures of regulation, irresponsible corporate decisions, cultural lack of commitment to conservation, or any other facet of the challenge that environmental limitations present. The factors that contribute to environmental harm are multiple. This reality does not justify dismissing any one such factor from review.

Some have observed a failure of commercial finance law to facilitate internalization or avoidance of environmental costs. UCC Article 9 was substantially revised in the 1990s and reenacted by state legislatures in 2001.<sup>72</sup> In the context of this debate, one member of the Article 9 Task Force of the ABA Subcommittee on Agriculture and Agri-Business Financing, Richard Barnes, cried out against the use of floating liens and purchase money security interests (PMSIs)<sup>73</sup> in farm financing. In a 1993 article, he declared passionately, “The farmer’s own interests and those of his secured financiers do not permit the type of commitment needed to conserve soil and reduce water pollution. Alternatives to the first-in-time priority system and the purchase money device are necessary to achieve the national commitment to protect soil and water.”<sup>74</sup>

The crux of Barnes’s argument is that UCC Article 9 emphasizes productivity over ecology in a way that influences how farmers conduct their businesses and that limits the effectiveness of laws meant to reduce pollution.<sup>75</sup> Barnes calls for land stewardship in the face of financing rules that enable agricultural practices that aggravate nonpoint source water pollution and deterioration of land quality. But his call has been, it seems, largely ignored. His article has received

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Sess., U.N. Doc. A/RES/56/81 (Dec. 12, 2001); *Nat’l Law Ctr. for Inter-Am. Free Trade, United Nations Group Drafting Secured Transactions Guide*, NOVEDADES, June 2006, at 1.

<sup>72</sup> One topic of much debate during the revision discussions was how to treat agricultural liens and security interests in farm assets. See Hughes, *supra* note 28, at 609–10.

<sup>73</sup> A PMSI arises when a secured party’s extension of credit enables the debtor to acquire new goods such as inventory or equipment. PMSIs have the benefit of special priority rules that grant them priority in advance of prior, perfected secured creditors with interests in after-acquired collateral. See U.C.C. §§ 9-103, -324 (2008).

<sup>74</sup> Barnes, *supra* note 20, at 512 (arguing that the unitary security interest and PMSI have aggravated environmental destruction of American farmland).

<sup>75</sup> *Id.* at 511–12.

few citations and the UCC drafting committee reports do not appear to address environmental concerns in their discussions of the new rules for agricultural finance.

This is not surprising, given major and obvious objections to this thinking. UCC Article 9 is neutral in the sense that it does not involve itself in the question of whether the secured transactions it governs are, in any given instance, positive-value or negative-value transactions. So, if we think critically about farmers and Article 9 finance, for example, Barnes argues that PMSIs encourage farmers to seek credit beyond what their primary bank lenders will provide in order to work the land beyond the point that the bank lenders think is appropriate—a point past which, in most cases, the farming activity will be environmentally harmful.<sup>76</sup> Perhaps this is a reason to limit the extent to which, under UCC Article 9, production money or purchase money lenders take priority over prior bank lenders in the farm financing context.

But we can just as easily think of a scenario where a primary bank lender is unwilling to extend additional credit to a farmer to produce a crop because the farmer wants to use new environmentally friendly techniques or machines, the results of which are less certain than traditional, environmentally hazardous methods. In this scenario, the availability of purchase money or production money credit for which the creditor will have a priority position in advance of the primary bank lender is a vehicle for sustainable practices.<sup>77</sup>

In the abstract, the floating lien and PMSI structure can be used to enter into transactions that harm the environment or, conversely, transactions that improve the environment. Yet, the actual results of farm practices in recent decades have been detrimental to vast amounts of land and water.<sup>78</sup> Farmers could not have undertaken

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<sup>76</sup> See *id.* at 464–65, 473–96.

<sup>77</sup> We could even craft enabling security-interest rules explicitly tailored for such types of investment. Article 9 could include an “environmental practices money security interest” that gives priority to investors extending credit to enable debtors to engage in practices specifically geared toward environmental stewardship. See Hughes, *supra* note 28 (exploring the concept of an “environmental practices money security interest” modeled on existing production money and PMSI rules).

<sup>78</sup> Barnes, along with others, identifies nonpoint source (NPS) water pollution as a serious environmental problem that has not responded adequately to top-down regulation because of the dispersed nature of its sources. See Barnes, *supra* note 20, at 496–501; J.B. Ruhl, *Farms, Their Environmental Harms, and Environmental Law*, 27 *ECOLOGICAL L.Q.* 263 (2000) (discussing how legal measures fail to respond to agricultural runoff).

these practices, it appears, without secured debt financing. So is this a UCC Article 9 problem or not?

The Code drafters, originally and through subsequent revision periods, have held that security interests in farm assets should be treated like any other security interest. Farmers and farm lenders should not operate under different financing rules despite the special nature of farming, including its relationship to land.

Barnes's argument seems to be that UCC Article 9 is complicit in environmental harm in that it induces behavior that aggravates farming's negative impact on the environment. Barnes is not alone in making this kind of charge against commercial finance rules. J. William Futrell writes about "law's prejudice against sustainability" and finds that this prejudice continues into the area of finance law.<sup>79</sup> Benjamin J. Richardson makes similar arguments about finance law in Canada.<sup>80</sup> He states, for example, that although Canada has greatly improved its environmental laws since the 1970s, a "lack of interaction between environmental and financial policy" creates for environmental law a great handicap.<sup>81</sup> "Because financial markets shape decisions concerning future development and thus resulting environmental pressures, the reform of investment, banking, and other financial services to promote more environmentally sensitive financing should be a government priority."<sup>82</sup>

These perspectives on commercial finance law build upon arguments that present environmental harm as a form of market failure.<sup>83</sup> We can understand Barnes to be making a context-specific version of an established argument that we recognize from the environmental movement more generally.

This argument contends that environmental harm is a market failure in that market transactions do not reflect costs of this harm.

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<sup>79</sup> J. William Futrell, *The Transition to Sustainable Development Law*, 21 PACE ENVTL. L. REV. 179, 188 (2003).

<sup>80</sup> See Benjamin J. Richardson, *Financing Environmental Change: A New Role for Canadian Environmental Law*, 49 MCGILL L.J. 145 (2004).

<sup>81</sup> *Id.* at 147.

<sup>82</sup> *Id.*

<sup>83</sup> For example, Nicholas Stern's influential report on climate change states: "Climate change presents a unique challenge for economists: it is the greatest and widest-ranging market failure ever seen." NICHOLAS STERN, STERN REVIEW: THE ECONOMICS OF CLIMATE CHANGE, EXECUTIVE SUMMARY i, available at [http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/stern\\_review\\_report.htm](http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/stern_review_report.htm) (last visited Nov. 18, 2011).



Negative environmental consequences are externalities of transactions—costs that are transferred to the public, not priced into transactions themselves. Because the law permits market actors to externalize environmental costs of their transactions, these costs are a form of market failure. The idea here is that a functioning market would discipline market actors to account for environmental harm and price transactions accordingly.

In the context of secured transactions, we could say that because debtors and secured lenders can enter into transactions that are profitable for them but have environmental consequences that are costly for the public, they are complicit in this market failure. Barnes finds the full-priority floating lien and PMSI to be collateral security devices that encourage just the sort of transactional activity that emphasizes short-term financial gains for private parties at the expense of harm to farmland.<sup>84</sup> So, we could say that threats to the environment are a UCC problem in the sense that the rules enacted in the UCC enable transactions that externalize environmental costs.<sup>85</sup>

This inquiry leads to another consideration. If environmental harm can be a UCC problem, then what about other types of costs the UCC rules could address? It is true that environmental challenges are unique and collective; but, at the same time, commercial actors are also in a position to alter other kinds of effects of commercial activity.

Thinking specifically about controversy surrounding suburban sprawl, there seems to be a direct connection between developers' incentives, the inability of land-use policies to control sprawl, and contemporary real estate finance practices. When specific commercial law rules yield effects that are controversial in particular circumstances, we should revisit these rules and consider the circumstances. The fact that commercial law rules may also produce other controversial effects does not justify an abandonment of commercial finance law to the current constellation of effects that it contemplates.

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<sup>84</sup> See Barnes, *supra* note 20, at 491.

<sup>85</sup> Part II.C explores this logic in more detail by considering it in the context of a specific type of transaction that permits transfer of risk and externalization of costs related to controversial environmental results.

## II

## CONTEXTUALIZED DISCUSSION: FINANCE AND SUBURBIA

Currently, the task of making value judgments about different approaches to growth is largely relegated to local governments and communities. This project suggests that the work of determining which approaches to growth are desirable could be taken up at the state level.

*A. Sprawl*

It is virtually impossible to speak categorically about a phenomenon as diverse and widespread as suburbanization.<sup>86</sup> The word “sprawl” has a negative connotation. Not all suburban developments contribute to sprawl, and the concept of sprawl is contested. Though many lament its negative environmental impact,<sup>87</sup> its causes, its benefits, and its drawbacks—attributes fundamental to its very definition—are subjects of debate.<sup>88</sup>

Below are two working definitions that attempt to capture the concept of sprawl. Edwin S. Mills states, “Sprawl means excessive suburbanization. Excessive means more than can be utility enhancing. Of course, how much suburbanization is utility enhancing depends on context. . . . Suburbanization has been both inevitable and mostly utility enhancing, but it can also be excessive.”<sup>89</sup> This definition relates sprawl to excess, and it implies that excess can be determined by a context-specific utility calculus (that would undoubtedly be highly complex).<sup>90</sup>

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<sup>86</sup> “Suburban studies” has produced numerous important texts, including ROBERT FISHMAN, *BOURGEOIS UTOPIAS* (1987); HAYDEN, *supra* note 2; KENNETH T. JACKSON, *CRABGRASS FRONTIER: THE SUBURBANIZATION OF THE UNITED STATES* (1985); NATURE IN FRAGMENTS: *THE LEGACY OF SPRAWL* (Elizabeth A. Johnson & Michael W. Klemens eds., 2005); ADAM ROME, *THE BULLDOZER IN THE COUNTRYSIDE: SUBURBAN SPRAWL AND THE RISE OF AMERICAN ENVIRONMENTALISM* (2001).

<sup>87</sup> See, e.g., *Stop Sprawl: Reports and Factsheets*, SIERRA CLUB, [www.sierraclub.org/sprawl/reports](http://www.sierraclub.org/sprawl/reports).

<sup>88</sup> See, e.g., BRUEGMANN, *supra* note 2; Edwin S. Mills, *Sprawl and Jurisdictional Fragmentation*, in BROOKINGS-WHARTON PAPERS ON URBAN AFFAIRS: 2006, at 231 (Gary Burtless & Janet Rothenberg Pack eds., 2006); Timothy J. Dowling, *Reflections on Urban Sprawl, Smart Growth, and the Fifth Amendment*, 148 U. PA. L. REV. 873, 874 (2000); Jeremy R. Meredith, *Sprawl and the New Urbanist Solution*, 89 VA. L. REV. 447 (2003).

<sup>89</sup> Mills, *supra* note 88.

<sup>90</sup> *Id.*

Taking a different kind of approach, Timothy J. Dowling defines sprawl as “low-density, land-consuming, automobile-dependent, haphazard, non-contiguous (or ‘leapfrog’) development on the fringe of settled areas . . . that intrudes into rural or other undeveloped areas.”<sup>91</sup> This kind of description is more detached from the concept of utility. In theory, a development could fit Dowling’s definition but still provide benefits that outweigh its associated costs. Dowling implies both that sprawl is problematic, regardless of the utility of any given development, and that sprawl creates costs to the environment or to communities that cannot be captured in a utility calculus.<sup>92</sup>

Court decisions on land use regulation have recognized concerns that sprawl implicates. In rejecting a Fifth Amendment takings claim against certain zoning ordinances, the U.S. Supreme Court has stated that it is clearly legitimate for local governments to discourage “the premature and unnecessary conversion of open-space land to urban uses.”<sup>93</sup> Yet, despite the validity of zoning that could effectuate well-planned growth, sprawl continues.<sup>94</sup> In fact, legal scholars have observed that most suburban zoning codes tend to promote, rather than discourage, sprawl.<sup>95</sup>

The Supreme Court has certainly never ordered local governments to protect open space; it has merely affirmed governments’ capacity to make rules to achieve this end if they so desire. Nonetheless, the Court identified in *Agins v. City of Tiburon* one of the issues at the core of the challenges that sprawling growth presents: premature and

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<sup>91</sup> Dowling, *supra* note 88. Dowling draws on a report by a local government association that defines sprawl as “low density, discontinuous, automobile-dependent, new development on the fringe of settled areas.” NAT’L ASS’N OF LOCAL GOV’T ENVTL. PROF’LS, PROFILES OF BUSINESS LEADERSHIP ON SMART GROWTH: NEW PARTNERSHIPS DEMONSTRATE THE ECONOMIC BENEFITS OF REDUCING SPRAWL 8 (1999).

<sup>92</sup> Dowling, *supra* note 88, at 887.

<sup>93</sup> *Agins v. City of Tiburon*, 447 U.S. 255, 261 (1980), *overruled by* *Lingle v. Chevron U.S.A., Inc.*, 544 U.S. 528, 548 (2005) (holding that whether a statute substantially advances a legitimate state interest is not a valid method of identifying regulatory takings for which just compensation is required). The Court’s 2005 decision altering the nature of takings analyses does not detract from the relevance, for this work, of the statement in *Agins* excerpted above.

<sup>94</sup> See William W. Buzbee, *Urban Sprawl, Federalism, and the Problem of Institutional Complexity*, 68 FORDHAM L. REV. 57 (1999); Henry R. Richmond, *Sprawl and Its Enemies: Why the Enemies are Losing*, 34 CONN. L. REV. 539 (2002).

<sup>95</sup> See Richard Briffault, *Localism and Regionalism*, 48 BUFF. L. REV. 1 (2000); Gerald E. Frug, *Against Centralization*, 48 BUFF. L. REV. 31 (2000).

unnecessary conversion of open-space land.<sup>96</sup> The pace of development and the possibilities for premature or unnecessary building are related to commercial finance practices like securitization and mezzanine lending.

Many commentators associate sprawl with both environmental and social problems. For example, some scholars focus on sprawl's negative impact on public or civic life.<sup>97</sup> Others focus on environmental problems associated with sprawl, such as increased carbon footprints of both houses themselves and the people living in them who need to drive more to reach services and jobs. Another environmental problem associated with sprawl is the consumption of natural resources that provide essential ecological services.<sup>98</sup>

Numerous scholars have studied the failure of zoning to contain growth patterns that are environmentally controversial.<sup>99</sup> They identify a range of causes for this, including consumer preferences,<sup>100</sup> municipal finance issues, and developers' use of SLAPP suits.<sup>101</sup> J.B. Ruhl and James Salzman write, "Every morning in cities across the

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<sup>96</sup> *Agins*, 447 U.S. at 261.

<sup>97</sup> See, e.g., DUANY ET AL., *supra* note 7 (discussing how a physical environment defined by sprawling development encourages a lack of community and communal space, and withdrawal from public life).

<sup>98</sup> See NATURE IN FRAGMENTS: THE LEGACY OF SPRAWL, *supra* note 86 (discussing sprawl's negative impact in terms of biodiversity, pollution, and overexploitation of resources); Elizabeth Farnsworth, *Scientific Solutions for Sprawl*, 88 *ECOLOGY* 531 (2007) (reviewing NATURE IN FRAGMENTS: THE LEGACY OF SPRAWL, *supra* note 86, and stating the need to bring scientific knowledge about sprawl's impact on the environment to local planning discussions on development). For a description of ecosystem services, see NATURE'S SERVICES: SOCIETAL DEPENDENCE ON NATURAL ECOSYSTEMS (Gretchen C. Daily ed., 1997); see also sources cited *supra* note 14.

<sup>99</sup> See, e.g., sources cited *supra* note 94.

<sup>100</sup> See ELIZABETH KOPITS ET AL., RESOURCES FOR THE FUTURE, RFF DP 09-15, LOT SIZE, ZONING, AND HOUSEHOLD PREFERENCES: IMPEDIMENTS TO SMART GROWTH? (2009), available at <http://www.rff.org/documents/RFF-DP-09-15.pdf>.

<sup>101</sup> "SLAPP" refers to "strategic lawsuits against public participation"—actions brought by developers against opponents of their projects in order to silence criticism. These suits may claim, for example, that parties who oppose developers' requests are interfering with a developer's business advantage or are conspiring with government actors to deprive developers of property rights without due process of law. These suits succeed when defendants are intimidated or unable to fight to establish their rights to speak out against projects they oppose. Litigants who do actively defend SLAPP suits have had success establishing a first amendment right to petition public officials. See, e.g., *Westfield Partners, Ltd. v. Hogan*, 740 F. Supp. 523 (N.D. Ill. 1990). Massachusetts has enacted a statute to protect against SLAPP suits. See MASS. GEN. LAWS ch. 231, § 59H (2010). See generally JOSEPH WILLIAM SINGER, PROPERTY LAW: RULES, POLICIES, AND PRACTICES 941-43 (4th ed. 2006).

nation, grumbling commuters inch along, locked in traffic gridlock, yet no local or regional planning agency can solve its cause—suburban sprawl.”<sup>102</sup> Ruhl and Salzman contend that sprawl is an example of a “massive problem”—a problem so big and unwieldy that it “has defied all variety of policy prescriptions.”<sup>103</sup> Ruhl and Salzman’s project concerns strategies for government agencies to “whittle away” at massive problems.<sup>104</sup> They observe that, in the case of sprawl, the mechanisms of the problem contain “components operating at different spatial and temporal scales, with causal feedback loops across and between scales. It is unlikely that any single level of government is better positioned than any other to address that kind of problem.”<sup>105</sup> Scholars like Ruhl and Salzman are seeking to develop new and better methods for regulators to control sprawl.

Debate continues over the advantages and disadvantages of sprawling development and “smart growth” and over which groups or governing bodies should make policy decisions about growth patterns.<sup>106</sup> While this debate unfolds, the inquiry in this Article concerns whether and how developers and financiers drive land-use outcomes *ex ante* by the sheer force of economic interests that can arise from current financing practices. The discussion here considers whether developers do, or should, have sufficient “skin in the game” with respect to projects to develop open space.

### *B. Securitization and Structured Finance in Real Estate Development*

Mezzanine loans are a common form of real estate development finance.<sup>107</sup> They enable real estate developers<sup>108</sup> to issue high-

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<sup>102</sup> J.B. Ruhl & James Salzman, *Climate Change, Dead Zones, and Massive Problems in the Administrative State: A Guide for Whittling Away*, 98 CALIF. L. REV. 59, 60 (2010).

<sup>103</sup> *Id.* at 64.

<sup>104</sup> *Id.* at 65.

<sup>105</sup> *Id.* at 65–66.

<sup>106</sup> See BRUEGMANN, *supra* note 2; Marcilynn A. Burke, *The Emperor’s New Clothes: Exposing the Failures of Regulating Land Use Through the Ballot Box*, 84 NOTRE DAME L. REV. 1453, 1476–86 (2009) (discussing the recent trend toward regulating land use with ballot initiatives and arguing that ballot box zoning results in deliberative failure and land use planning failure); William W. Buzbee, *Sprawl’s Dynamics: A Comparative Institutional Analysis Critique*, 35 WAKE FOREST L. REV. 509, 519 (2000) (analyzing the issue of ‘deciding who decides’ in the context of policy questions surrounding sprawl).

<sup>107</sup> For a general discussion of mezzanine lending, see Joseph Philip Forte, *Mezzanine Finance: A Legal Background*, in COMMERCIAL SECURITIZATION FOR REAL ESTATE

priority debt to fund the development of housing. Developers may also use another transactional structure, such as a preferred equity investment or a junior mortgage. A large, publicly traded developer may undertake projects on its own. For reasons discussed below, mezzanine lending and preferred equity investments have become far more common than junior mortgages.<sup>109</sup>

Developers typically acquire realty with a mortgage loan; the mortgagee has a first-priority lien on the land and will lend only up to some percentage of its appraised value. Once a development company has acquired real estate, it then seeks capital to undertake construction on the land.

The company may fund the development with contributions from the individuals or entities that are participating in the project—typically, members in an LLC that constitutes the development company for a given project. But in many instances these participants do not raise funds beyond what is necessary to form the LLC and acquire (again, usually with a mortgage loan) the undeveloped land. So in order to fund construction, they may assign a security interest in their equity in the project entity to obtain a loan from an outside financier—frequently, a mezzanine lender.<sup>110</sup> By doing this, they

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LAWYERS 437 (ALI-ABA Course of Study Materials Ser. No. SJ090, 2004); Steven G. Horowitz & Lise Morrow, *Mezzanine Financing*, in REAL ESTATE FINANCING DOCUMENTATION: STRATEGIES FOR CHANGING TIMES 541 (ALI-ABA Course of Study Materials Ser. No. SJ005, 2004).

<sup>108</sup> The term “developer” can mean equity participants in a real estate development project or it can mean the person or entity that contracts with builders, lawyers, and others to undertake the project. Here, “developers” refers to the persons who identify and undertake real estate development projects in pursuit of the profits derived from sale or lease of the improved property.

<sup>109</sup> See generally Andrew R. Berman, “Once a Mortgage, Always a Mortgage”—*The Use (and Misuse of) Mezzanine Loans and Preferred Equity Investments*, 11 STAN. J.L. BUS. & FIN. 76 (2005) (discussing the effects of securitization on real estate financing practices). The purpose here is to examine the relationship between one very common form of secured transaction and the environmental consequences of the activities it funds. We could make similar inquiries of other transactional structures as well. For other variations of transactions for real estate development, see John C. Murray, *Clogging Revisited*, 33 REAL PROP. PROB. & TR. J. 279 (1998).

<sup>110</sup> Mezzanine loan deals typically involve an inter-creditor agreement between the mortgage lender and the mezzanine lender under which the mortgage lender agrees, among other things, to permit the mezzanine lender to cure any defaults on the mortgage loan. For a discussion of these inter-creditor agreements, see Ellen M. Goodwin, *Mezzanine Finance: Senior Lender Form of Intercreditor Agreement*, in COMMERCIAL REAL ESTATE FINANCE 2002: WHAT BORROWERS AND LENDERS NEED TO KNOW NOW 997 (PLI Real Estate Law & Practice, Course Handbook Ser. No. N-478, 2002).

transfer much of the risk to outside investors if the project fails, while still retaining the right to profit if it succeeds.

Scholars report that participant equity is typically five to ten percent, with the combination of mortgage and mezzanine lending providing approximately ninety percent of a typical real estate development project's capital structure cost.<sup>111</sup> In theory, a developer could raise funds with a mezzanine loan and not necessarily leverage a project to ninety percent of its capital costs. But in practice, mezzanine loans are used to generate high degrees of leverage; they are priced and structured to fill the gap between what mortgage lenders will fund and the project's capital requirements.<sup>112</sup>

Mezzanine loans are governed by UCC Article 9, and the collateral assigned to the lender is typically one hundred percent of the membership interests in an LLC that owns land for development. The mezzanine borrower (the obligor on the loan) is an LLC. This LLC has a wholly owned subsidiary—another LLC—that owns the underlying realty. The borrower assigns a security interest to the mezzanine lender in the membership interests of the subsidiary LLC that holds the land.<sup>113</sup> The real estate developers themselves—the participants in the project—are the members—the equity holders—of the mezzanine borrower.

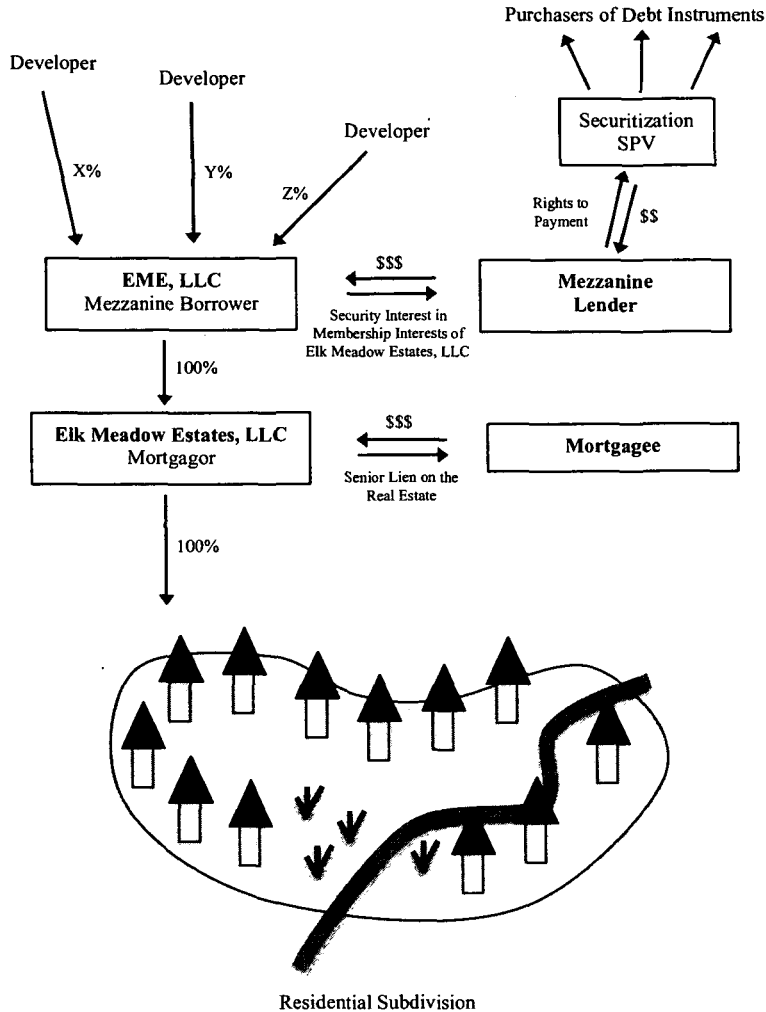
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<sup>111</sup> See Murray, *supra* note 109, at 302.

<sup>112</sup> See Berman, *supra* note 109; Murray, *supra* note 109.

<sup>113</sup> While in everyday speech we may use “debtor” interchangeably with “borrower,” under Article 9 a debtor is a party that assigns a security interest in property, regardless of whether the debtor is also an obligor (a party obligated to repay the loan). See U.C.C. § 9-102(a)(28), (59) (2005) (defining “debtor” and “obligor,” respectively).

### Securitized Mezzanine Lending



One key feature of these transactions is an inter-creditor agreement between the mezzanine lender and the senior mortgage lender. This agreement establishes several rights of the mezzanine lender that make the transaction attractive.<sup>114</sup> Though these rights can vary from

<sup>114</sup> See Goodwin, *supra* note 110.



deal to deal, they often include the right to receive any notices of default on the senior mortgage, along with rights to cure any defaults and the right to receive the proceeds of any sales of new homes in the development in advance of participants in the project, such as the senior mortgage lender or owner. Senior mortgage lenders agree to these provisions because the mezzanine lender provides capital for improvement of the property that increases its value, which increases the value of the mortgage lender's collateral and thereby improves the mortgage lender's position.

The mezzanine lender is willing to do this because it typically charges a higher interest rate and has rights to foreclose on its collateral to become the owner of the entity that holds title to the land and that is obligated on the mortgage.<sup>115</sup> This, in combination with its rights under the inter-creditor agreement and its right to proceeds of sales, makes mezzanine lending attractive.

From the developers' perspective, these deals are attractive because they provide capital beyond what a mortgage lender will provide for improvement of land. By creating an LLC that holds title to the land, the developer creates a new class of collateral that can be assigned to raise capital with debt. The value of the LLC membership interests is not necessarily limited to the value of the realty itself in its unimproved state. Rather, the value of this entity includes its potential—its development permits and other rights, its investment in architectural planning, and its contract rights. Mezzanine lending is a way for developers to capture and leverage all of the value of a project that exists in addition to the appraised value of the unimproved real estate.

A mezzanine loan is typically nonrecourse, meaning that the lender has recourse only to its collateral—membership interests in an LLC—and not to other assets of the debtor or assets of the debtor's owners. (The debtor is typically a special-purpose company that has no assets other than the membership interests in the project company.) However, mezzanine lenders often include some carve-outs to the

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<sup>115</sup> This is not to say that mezzanine lenders have an easy time recovering the value of their claims in the event of default. The structure of mezzanine lending—especially the inter-creditor agreement—is designed to facilitate avoidance of default or bankruptcy, not to position the mezzanine lender for recovery of valuable assets upon default. See Berman, *supra* note 21 (discussing the challenges that mezzanine lenders face when they attempt to recover value from their debtors through foreclosure, given that their collateral is the equity of an entity rather than the underlying realty).

nonrecourse provisions, namely for negligence or other misbehavior on the part of the project's owners. These carve-outs prevent developers from transferring risk created by their own bad actions.

If the new homes are never completed, do not sell, or do not sell at a profit, then the project company, and the equity interests of its owner, are valued accordingly. The members lose what they put in to acquire the interests: a relatively small amount if the project company acquired land with a mortgage loan and undertook construction with proceeds of mezzanine financing. If the project is completed and the homes sell at projected prices, the members of its owner get the difference between the mortgage and mezzanine loan amounts (with interest) and the total proceeds of home sales.

There are, of course, many different types of developers and development ventures, some of which are more vulnerable to the failure of any given project than others. A small developer may use mezzanine lending to undertake a project but nevertheless be very vulnerable to reputational risk or personal financial risk, even though initial outlays of capital are relatively small. The type of risk shifting that this work contemplates is in contexts where a development company with a portfolio of projects minimizes its exposure to risk in a way that facilitates undertaking a high volume of development.

For purposes of UCC Article 9, LLC membership interests are, in most cases, general intangibles.<sup>116</sup> Membership interests can be investment property in cases where the members so designate in their operating agreement.<sup>117</sup> In some cases, mezzanine lenders require that the equity of the LLC in which they take an interest be designated as securities in accordance with UCC Article 8 (governing investment property). The lenders then perfect their interests by taking control of the interests.<sup>118</sup> They may also file a UCC-1 financing statement to give additional notice of their interests.

From an Article 9 perspective, the rules for creation, attachment, and perfection of the security interest in mezzanine financing are straightforward. For one thing, these transactions involve only one

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<sup>116</sup> This is a catch-all category of personal property that does not fit any of the other collateral definitions. *See* U.C.C. § 9-102(a)(42).

<sup>117</sup> *See id.* § 8-103(c).

<sup>118</sup> Membership interests in LLCs that are investment property may be certificated or uncertificated securities. *Id.*

type of personal property collateral.<sup>119</sup> Mezzanine lenders will undertake a title review and other diligence as if they were making mortgage loans because the equity interests that are their collateral are in project entities that exist only to hold title to (and limit liability surrounding) real estate.<sup>120</sup> Because the collateral is LLC membership interests and not realty, the lender need only follow the Article 9 rules for creation and perfection of its interest. Namely, the parties meet the criteria in UCC section 9-203 for creation and attachment of a valid security interest,<sup>121</sup> and the lender perfects its interest by filing a UCC-1 financing statement in the jurisdiction in which the debtor is located<sup>122</sup> or, in cases in which the LLC members opt into UCC Article 8, by establishing control of the collateral.<sup>123</sup>

In the early years of mezzanine financing, mezzanine lenders might have been individuals or other real estate development companies that wanted to participate in a project, but did not want, for whatever reason, to have an equity position.<sup>124</sup> This approach to mezzanine finance, however, has been dwarfed since the 1990s by institutional lenders creating mezzanine loan portfolios that they themselves sell or assign to raise capital. Many real estate development companies are not required to report the capital structures of their projects. Numerous sources refer to a surge in popularity of mezzanine finance since the 1990s and to the fact that developers often use this type of

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<sup>119</sup> Cf. Berman, *supra* note 21, at 1030 (describing mezzanine lending as complex in the sense that these loans can raise complex questions, and that issues surrounding lenders' options for realizing value out of mezzanine loan collateral in foreclosure can be complex).

<sup>120</sup> In fact, Berman has argued that mezzanine loans (and preferred equity financing for real estate development) should be treated as mortgage substitutes. See Berman, *supra* note 109.

<sup>121</sup> See U.C.C. § 9-203 (specifying that to create a valid interest, the creditor must give value, the debtor must have rights in the collateral, and the parties must enter into an agreement—which may be evidenced in a range of ways—under which the debtor assigns a security interest).

<sup>122</sup> See *id.* §§ 9-310(a), -301, -307.

<sup>123</sup> *Id.* §§ 8-106, 9-313, 9-314. The method of establishing control of membership interests that are investment property varies depending on whether the interests are certificated or uncertificated. See *id.* § 8-106.

<sup>124</sup> Note that the position of a mezzanine lender is very similar to an equity position because the borrower has no other creditors and the collateral is one hundred percent of equity interests in a special-purpose company. See Georgette Chapman Poindexter, *Dequity: The Blurring of Debt and Equity in Securitized Real Estate Financing*, 2 BERKELEY BUS. L.J. 233, 240 (2005).

loan.<sup>125</sup> A Moody's Investors Service report states that in 2006, issuances of mezzanine debt in CDOs were valued at "approximately \$3.22 billion."<sup>126</sup> While this number does not indicate what portion of developments was funded with mezzanine lending, it does give a sense of the size of the securitized mezzanine loan market in 2006.

The rise of mezzanine finance has been a function of the rise of securitization itself. The relationship between mezzanine lending and securitization has two facets. First, mezzanine lenders often securitize mezzanine loans themselves, raising money through capital markets to fund mezzanine loans. Second, securitization facilities for mortgage loans frequently prohibit mortgage debtors from incurring other significant debt. The structure of mezzanine lending enables new debt that does not run afoul of this prohibition. Scholars, such as Georgette Chapman Phillips, have observed, "The mezzanine lending market grew in the United States in response to the limitation on debt financing in many securitized transactions."<sup>127</sup>

When a developer raises funds with a mezzanine loan, it in effect shifts risk of a project's failure to the mezzanine lender. The mezzanine lender is often a large institutional financier that in turn shifts the risk associated with the projects it funds to investors through securitization. Because the structure of securitized mezzanine finance enables shifting of risk from the developer to the lender and from the lender to capital markets, mezzanine finance can create incentives to develop more land in a more speculative manner than the developer otherwise could or would.<sup>128</sup> Again, there is

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<sup>125</sup> See, e.g., Berman, *supra* note 21, at 996; Paul Rubin, *Strategic Thinking for the Mezzanine Lender*, AM. BANKR. INST. J., Oct. 2009, at 42 (referring to the "popular use" of these loans since the 1990s).

<sup>126</sup> DANIEL B. RUBOCK, MOODY'S INVESTORS SERV., US CMBS AND CRE CDO: MOODY'S APPROACH TO RATING COMMERCIAL REAL ESTATE MEZZANINE LOANS 2 (2007), available at <http://dirt.umkc.edu/attachments/MDYMezz%20Loans.pdf>.

<sup>127</sup> Georgette Chapman Phillips, *The Paradox of Commercial Real Estate Debt*, 42 CORNELL INT'L L.J. 335, 358 (2009).

<sup>128</sup> Andrew Berman, in the course of arguing that mezzanine loans should be treated by courts as mortgage substitutes, notes that these loans can induce unnecessary risks as lenders miscalculate courts' willingness to treat them as loans secured by equity, and not as subordinated debt secured by real estate. "By failing to take into account certain inherent risks associated with secured subordinated financing, mezzanine lenders and preferred equity investors invariably engage in riskier lending practices either by over-extending credit or under-pricing loans. These practices all lead to unnecessary risk taking by all of the market participants." Berman, *supra* note 109, at 122 (discussing the risk associated with characterization of mezzanine loans after default). Note that other scholars

nothing inherently wrong with risk transfer; risk transfer is at the heart of many common financial transactions. It enables borrowers to undertake projects that would not otherwise have funding, yielding important new development and growth. In certain contexts, however, risk transfer creates moral hazard and aggravates externalities surrounding commercial transactions.<sup>129</sup> The project, here, is to consider the extent to which development of open-space land is a context in which risk transfer by real estate financiers can aggravate controversial environmental results.

Given the environmental impacts associated with certain modes of real estate development, perhaps we ought to consider the possibility of instituting special rules pertaining to these transactions in some contexts. If we link a given secured transaction to the environmental consequences of the activities it funds, we may, for example, consider possibilities for a regulatory subject—a “mezzanine finance limited liability company”—that commercial law rules could define in order to reshape the capacities of certain types of private actors.<sup>130</sup>

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do not agree with the notion that mezzanine loans should be treated like subordinated debt secured by realty. See Phillips, *supra* note 127.

<sup>129</sup> See *supra* note 9.

<sup>130</sup> It is beyond the scope of this Article to make a policy proposal. Conceptually, though, one idea to explore might be an “Open Space Development LLC Act.” State legislatures could enact new statutory rules either within or apart from UCC Article 9 that govern assignment of interests in LLCs that hold open space for development. Environmentalists have made arguments, in the real property context, about areas of land being differently situated such that not all land should be alienable in the same way. See ERIC FREYFOGLE, *THE LAND WE SHARE* (2003). These arguments could inform a rethinking of the various classes of personal property and the commercial law rules that govern their assignment as security. We could imagine, for example, an equity carve-out to assignments of interests in “mezzanine finance LLCs” holding the equity of an entity that holds undeveloped land that is zoned for residential housing on lots of a certain size. This type of act would need to define “mezzanine finance LLC” and then determine some percentage beyond which interests in this type of LLC may not be assigned to secure a loan.

This type of equity carve-out would not stop any particular kind of development. It would merely make a certain source of capital unavailable beyond a defined threshold in certain contexts. Any development could proceed, but in contexts involving a “mezzanine finance LLC,” only a certain percentage of the membership interests of the project entity holding land would be assignable as security. The idea would be to ensure that developers have “skin in the game” when they undertake certain kinds of projects by prohibiting assignment of one hundred percent of the membership interests in LLCs in certain contexts. This could minimize developers’ capacity to transfer market risk and externalize environmental risk in situations in which developers may be building at an accelerated pace to meet demands that are not sustainable, either environmentally or in terms of continuing housing market expansion.

We are all aware of the 2007 crash of the real estate market, the collapse in value of many mortgage-backed securities, and the resulting effects on financial institutions. This crisis—and the public response to it—has not prompted fundamental refiguring of the practices of securitization or mezzanine lending. Public discourse has focused overwhelmingly on ensuring that these types of transactions are well executed and involve sufficient due diligence.<sup>131</sup> The discussion seems to focus primarily on recovery of the market.

A recovered or healthy market will undoubtedly involve securitized mezzanine lending. These transactions will continue—only the pace may be different, but even this remains to be seen. In fact, ABA-CLE advertises materials (first available in May 2010)

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If a developer could not raise funds to build on open space by assigning all of the equity of the project LLC to an institutional mezzanine lender, then the developer would have to more carefully assess the project to ensure that it would be value-adding, at least from the perspectives of the builder and the potential buyers.

Financiers could innovate, of course, to generate a new form of transaction that replaces mezzanine finance. If they do, then lawmakers could examine whether new financing practices affect land use results in a way that warrants review.

Of course, statutory limits on certain types of security interests are just one possible idea to consider. A different approach might look to commercial actors themselves, rather than legislation. Institutional lenders could include provisions in mezzanine financing contracts that create threatening levels of recourse if developers disregard environmental objectives.

For example, lenders could require an environmental impact assessment of a prospective development that includes a report on the development's projected carbon footprint. The lender could then include, in its financing documents, covenants that require the developers to build in a way that meets certain objectives to reduce the development's carbon footprint. These requirements could be as stringent as requiring the use of certain materials and energy sources, or as minimal as requiring that the development contain foot and bicycle paths that provide access to a bus stop. Costs of enforcing these covenants, and any damages for breach, could be sought from the members of the mezzanine borrower—the developers themselves—and not just from the proceeds or value derived from the equity of the development LLC.

The lender could require the developer to draft underlying homeowner association covenants to include things like fees that support energy-efficient transportation from the neighborhood to shopping or other common destinations. Once the homes were sold, of course, maintenance of this obligation would no longer be within the lender's or developer's control. It would be up to the new association to continue these activities. These contract-based approaches would suffer the same limitations as the Equator Principles and Carbon Principles discussed above. Nothing obligates a lender to call an event of default or to seek remedies in response to any given contractual default.

<sup>131</sup> For example, there has been much outcry about mortgage loans made to borrowers in contexts in which the originators did nothing to verify borrowers' ability to pay, selling the loans into securitization facilities such that risk of borrower nonpayment was not their concern. At the same time, banks invested in mortgage-backed securities without demanding substantiation of the quality of the underlying loans.

covering the issue that “[p]ermanent lenders are financing now at lower loan to value ratios than previously and mezzanine financing is a key tool to bridging the equity gap.”<sup>132</sup> In other words, as mortgage lenders return to requiring that borrowers have some equity in property, mezzanine lending becomes an important way to continue development practices that depend on higher degrees of leverage.

*C. Is Sprawl a Function of Commercial Finance Law, or Is It Not?*

Suburban sprawl is intensely controversial. Many scholars associate it with grave environmental challenges, as well as with social and cultural challenges. New residential subdivisions get built with the proceeds of certain, identifiable forms of debt finance transaction. This Section seeks to define the relationship between these two realities.

*1. How Can We Say that Mezzanine Finance Itself Escalates Certain Types of Development? And Why Focus on Securitized Mezzanine Finance as Opposed to Monetary Policy or Factors Altogether Apart from Finance?*

No single form of transaction determines what developers will build. Monetary policy, some might say, is the driving factor in housing development and markets: when interest rates are low and buyer demand is high, there will be new housing developments. But at the same time, the pace of development bears at least some relationship to the degree of leverage and risk transfer that structured finance enables.

The inquiries at issue here might be relevant to other transaction structures that facilitate transfer of risk and leverage, such as securitization generally. This discussion targets securitized mezzanine lending in particular because it is a commercial finance practice in which the parties are sufficiently proximate to the underlying development to control and anticipate its environmental effects, and yet at the same time, the parties are raising funds through capital markets.

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<sup>132</sup> See *ABA Web Store*, AM. BAR ASS'N, <http://apps.americanbar.org/abastore/index.cfm?section=main&fm=Product.AddToCart&pid=5430528CD> (last visited Nov. 18, 2011) (advertising ABA-CLE, *Mezzanine Financing: Bridging the Gap in Loan Refinancings* CD-ROM, May 2010).

The mezzanine loan is a commonly used form of financial transaction that permits developers to leverage projects beyond what other financing structures allow.<sup>133</sup> While securitization expands access to capital for financing development, mezzanine lending provides the structure for the degree of leverage that certain modes of development require.<sup>134</sup>

The use of the LLC to hold title to realty and act as mezzanine borrower creates a class of collateral that was not otherwise available for assignment. We could discuss securitization, or “cheap money” generally, but if the purpose of this inquiry is to consider the connection between secured transactions and environmental consequences, then the mezzanine loan is particularly relevant. The point here is not to say that certain developments happen “because of” mezzanine loans rather than, say, consumer preferences or cheap gasoline, among other things. To say that mezzanine finance facilitates certain modes of development is not to isolate it as the only factor doing this.

For purposes of thinking through the relationship between commercial finance rules and environmental results, the securitized mezzanine loan stands out as a transaction operating at the core of a controversial environmental phenomenon: suburban sprawl. While other transactional forms for leveraging real estate development projects certainly exist, commercial transactions tend toward path dependency. Once highly evolved form documentation for a particular structure exists, parties tend to repeat the structure. This repetition and standardization of transaction forms is part of what facilitates the large-scale packaging and sale of the transactions for securitization.<sup>135</sup>

We might say that mezzanine financing itself escalates certain types of development because it expands access to capital for developers using standardized transactional forms in which financiers

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<sup>133</sup> See *supra* Part II.B.

<sup>134</sup> Again, it is a widespread, established form of finance for leveraging real estate development projects beyond what is possible with mortgage lenders. See *supra* Part II.B.

<sup>135</sup> Numerous scholars have discussed path dependency and form documentation in commercial transactions. See, e.g., Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or “the Economics of Boilerplate”)*, 83 VA. L. REV. 713, 718 (1997); Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CALIF. L. REV. 479 (1998); David V. Snyder, *Private Lawmaking*, 64 OHIO ST. L.J. 371 (2003).



take a security interest in standardized types of collateral. An institutional lender will have form documentation for making loans to developers building certain types of new residential subdivisions. If the mezzanine lender funds these loans with proceeds of securitization transactions, it may have standing securitization facilities into which new loans to developers are directed. What this implies for land-use results on the ground is that investors may have already reviewed and approved of form documentation for loans to developers secured by certain types of housing development. When market conditions support new home building and buying, there can be a kind of queue of funding for projects fitting the preapproved formula—a formula at odds with objectives like open-space preservation, for example.

*2. Even if Mezzanine Finance Does Escalate Certain Modes of Development, Why Design Finance Rules in Order to Alter Effects of Transactions? And by What Logic Is Environmental Impact a Mezzanine Lending Issue?*

A recent discussion paper published by Resources for the Future<sup>136</sup> reports economists' findings in a study of lot sizes, zoning, and household preferences.<sup>137</sup> The authors report, "To the extent that communities want to slow the rate of growth of land used in development, and promote smart growth policies, there will need to be a move toward higher density."<sup>138</sup> The economists' findings indicate that zoning is not an effective tool for achieving higher-density housing.<sup>139</sup> "An important contributor to this fact," they observe, "may be that people have preferences for space and larger lots. This remains a difficult challenge for achieving smart growth outcomes."<sup>140</sup>

Numerous studies have documented a trend in recent decades toward larger home sizes, which are occupied by families of fewer people.<sup>141</sup> Mortgage securitization and the introduction of new

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<sup>136</sup> Resources for the Future is a nonpartisan, nonprofit environmental research group. RESOURCES FOR THE FUTURE, <http://www.rff.org/Pages/default.aspx> (last visited Nov. 9, 2011).

<sup>137</sup> KOPITS ET AL., *supra* note 100.

<sup>138</sup> *Id.* at 21.

<sup>139</sup> *Id.*

<sup>140</sup> *Id.*

<sup>141</sup> See, e.g., HAYDEN, *supra* note 2; KOPITS ET AL., *supra* note 100.

residential home mortgage products in recent years expanded accessibility to larger houses for many buyers.<sup>142</sup> At the same time, mezzanine financing and the securitization of mezzanine loan portfolios have contributed to real estate developers' capacity to build new homes in tandem with increased demand.

People want new homes and, apparently, low-density housing.<sup>143</sup> The prevailing view is that while shoddy due diligence on the part of financiers is bad, there is nothing bad about growth itself or speculation *per se*, or the underlying transactional structures with which we finance them. Mezzanine finance simply maximizes access to capital for developers, which can lead to more housing that is available at lower costs to buyers (where developers pass savings in costs of capital through to buyers).

While mezzanine finance greases<sup>144</sup> practices that many say aggravate environmental problems, this mode of finance could just as readily fund "smart growth" or the construction of environmentally progressive communities.<sup>145</sup> As John Steinbeck asks in *The Grapes*

<sup>142</sup> See ZYWICKI, *supra* note 12 (discussing the proliferation of high-income, subprime borrowers, and their impact on the foreclosure crisis).

<sup>143</sup> The idea that mezzanine finance merely accomplishes fulfillment of consumer preferences sidesteps important questions about these preferences. Doug Kysar notes that the political community can be "tempted by the notion that its regulations and policy pronouncements can simply trace individual preferences, without also endogenously affecting them." DOUGLAS A. KYSTAR, *REGULATING FROM NOWHERE: ENVIRONMENTAL LAW AND THE SEARCH FOR OBJECTIVITY* 17 (2010). We cannot conclude that current patterns of development are good because they reflect consumer preferences; these preferences themselves will change with the landscape they transform using currently available tools and policies. The disappearance of open space itself will change our culture, expectations, and preferences. Recent scholarship discusses how the environmental movement must transform in the face of disappearance of places untouched by humans. See PAUL WAPNER, *LIVING THROUGH THE END OF NATURE: THE FUTURE OF AMERICAN ENVIRONMENTALISM* 210 (2010) (arguing that, given impending disappearance of nature or wilderness, neither the dream of naturalism nor the dream of mastery over nature can survive, leaving a breached boundary between humans and nature that requires a new coevolutionary path).

<sup>144</sup> The use of chemicals as metaphor—grease, fuel, friction eliminators—is deliberate, as environmental law has an established history of approving chemicals for use in some contexts but not others. Chemicals that are useful and important for some places and processes are lethal in others.

<sup>145</sup> A range of such communities has cropped up in recent years. See, e.g., Jason Blevins, "Agriburbia" *Sprouts on Colorado's Front Range*, DENV. POST, Oct. 24, 2009, [http://www.denverpost.com/ci\\_13631048](http://www.denverpost.com/ci_13631048) (describing the practice of allocating some lots in a subdivision for growing vegetables and other plants). Though interesting, these examples are relatively small-scale anomalies to standard development patterns.

of *Wrath* (and Barnes excerpts in his critique of UCC Article 9): "Is a tractor bad? Is the power that turns the long furrows wrong?"<sup>146</sup>

Obviously there are many factors other than commercial finance that shape and fuel the phenomenon of suburbanization and its complex implications: tax subsidies for home mortgages, zoning and local government objectives, and highway infrastructure, to name a few. Mezzanine lending may appear, compared to these factors, like a behind-the-scenes detail. Any real collective action to address issues that suburbanization presents should take place in the public fora for addressing zoning and regulation. Mezzanine lenders and borrowers are just squirrels getting their nuts from a pattern of development that results from larger forces. If certain kinds of development are in fact undesirable, they should be taxed.

Yet, as difficult, collective issues surrounding sprawling development simmer in public discourse, mezzanine lending makes it possible for real estate developers to maximize the pace of building. It is not clear what the best approach to land use is. Communities deliberate over complex, multifaceted goals, such as desire to have open space and desire to have new neighborhoods to support the tax base and to attract new residents. These deliberations may not be resolvable using cost-benefit concepts. They invoke deep challenges surrounding the coexistence of a love of nature and a tolerance of loss.<sup>147</sup>

Even dramatically increased consumer commitment to conservation may not curtail environmentally problematic growth patterns because even the most evolved environmentalist ethic encounters the paradox that people at the same time love the natural

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<sup>146</sup> JOHN STEINBECK, *THE GRAPES OF WRATH* 151 (Penguin Books 1999) (1939); Barnes, *supra* note 20, at 458. There is an instrumentalist aesthetic at play in commercial law—an aesthetic in which law has the properties of a physical object. The notion that law is a tool implies that law has a utility detached from cultural or ideological commitments. See Hughes, *supra* note 20, at 723–29. This thinking builds on Annalise Riles's observation that "[t]he principal insight of Realism was that law was best imagined *metaphorically* as a tool," but at some point in the twentieth century "the idea that law was like a tool quite literally became a tool of its own." Riles, *supra* note 53, at 980–81 (discussing aesthetic dimensions of technocratic approaches to law). In the commercial law context, the idea that commercial law is a tool has become a tool of its own. The metaphor of commercial law as a tool is itself a tool useful for emphasizing commercial law's neutrality with respect to the effects of the transactions it governs.

<sup>147</sup> See NICHOLSEN, *supra* note 3.

environment and feel indifferent toward its destruction.<sup>148</sup> A choice by a consumer to buy a house with a large carbon footprint in a previously undeveloped area despite knowledge of and concern for environmental impact is not a simple expression of preference that public policy should ratify.<sup>149</sup>

We could say that environmental consequences of suburban sprawl are a commercial finance problem because securitized mezzanine lending enables real estate development to outpace the process by which communities should make decisions about growth. Commercial finance laws create an appetizing buffet of opportunities to profit from developing land into new residential subdivisions. While communities, institutions, and individuals struggle with the value and meaning of open space, transactional structures designed to maximize access to capital for certain types of development enable a fast pace of land consumption.

New low-density housing has been (and will be) in demand. The benefits and costs associated with it are complex to assess; the normative values that give structure to cost-benefit analyses of real estate development require ongoing, collective determination.<sup>150</sup> Suburbanization of open space raises controversies that

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<sup>148</sup> Environmentalists and psychoanalysts have explored this paradox and its effects on behavior concerning the environment. See, e.g., NICHOLSEN, *supra* note 3; HAROLD F. SEARLES, *Unconscious Processes in Relation to the Environmental Crisis*, in COUNTERTRANSFERENCE AND RELATED SUBJECTS 228, 229 (1979) (contending that we are hampered in meeting the environmental crisis by a severe and pervasive apathy which is based largely upon feelings of which we are unconscious); GARY SNYDER, *THE PRACTICE OF THE WILD* (1990) (exploring the depth and complexity of our relationship to the wild).

<sup>149</sup> A 2005 study assessing public discourse about sprawl found high levels of concern about environmental impact and increases in traffic; yet, sprawling development has not abated. See David N. Bengston et al., *An Analysis of Public Discourse on Urban Sprawl in the United States: Monitoring Concern About Major Threats to Forests*, 7 FOREST POL'Y & ECON. 745, 745–56 (2005) (assessing computer content analysis of media and public reports on sprawl and finding increasing levels of concern for loss of open space and other environmental impacts of sprawl). Some scholars attribute this to the “power of the American dream.” See, e.g., Mark S. Davies, *Understanding Sprawl: Lessons from Architecture for Legal Scholars*, 99 MICH. L. REV. 1520, 1525 (2001) (reviewing ANDRÉS DUANY ET AL., *supra* note 7). Other scholars have explored the ways in which consumer preferences and choices relate to identity formation and expression. See LIZABETH COHEN, *A CONSUMERS' REPUBLIC: THE POLITICS OF MASS CONSUMPTION IN POSTWAR AMERICA* (2003).

<sup>150</sup> Cf. Kysar, *supra* note 20 (discussing how cost-benefit analyses animate underlying values and arguing for ecological economics or cost-benefit analyses that incorporate limits on the natural environment's capacity to sustain growth).

environmental regulation struggles to address, such as, for example, loss of large predator habitat.<sup>151</sup> Low-density development is not necessarily containable through zoning.<sup>152</sup> Disagreement, conflict, hopes, and aspirations surround this type of development.<sup>153</sup>

As long as it is a good bet that homes of a certain size will sell at a certain price point in a given location, mezzanine lending expands access to capital for developers to place the bet. Not all of these bets need to be successful. In this way, securitized mezzanine finance can enable developers to engage in “premature or unnecessary conversion of open-space land for urban uses.”<sup>154</sup> They can begin clearing off habitats, grading roads over fields, and the like, in anticipation of success. But if it looks like the bet is not a good one, developers can cease construction or leave houses sitting partially built.<sup>155</sup> If the relevant project company defaults on loans, then the mortgagee recovers the value of the land. Dealing with whatever value is left in the project is the mezzanine lender’s problem.<sup>156</sup> The mezzanine lender, in turn, has often transferred this risk to others by securitizing its mezzanine loan portfolio.

One might say that if mezzanine finance were no longer available at the lowest possible cost, then developers would simply use junior mortgages to leverage their projects. This may be true, but junior

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<sup>151</sup> Large predators such as bears and wolves require long corridors over which to travel. They cover too much ground to coexist with people in a landscape divided up by development. The protection of specific areas in the forms of public parks and preserves is not adequate to accommodate these animals. See REAL ESTATE RESEARCH CORP., *THE COSTS OF SPRAWL: ENVIRONMENTAL AND ECONOMIC COSTS OF ALTERNATIVE RESIDENTIAL DEVELOPMENT PATTERNS AT THE URBAN FRINGE* 142 (1974); Robert W. Burchell, *Economic and Fiscal Costs (and Benefits) of Sprawl*, 29 URB. LAW. 159, 168–69 (1997); Bradley C. Karkkainen, *Biodiversity and Land*, 83 CORNELL L. REV. 1 (1997).

<sup>152</sup> See KOPITS ET AL., *supra* note 100; see also sources cited *supra* note 95.

<sup>153</sup> Cf. MIT Press, *Back cover* to ELIZABETH FARRELLY, *BLUBBERLAND: THE DANGERS OF HAPPINESS* (2008) (assessing consumption, its eco-footprint, and a state of mind in which we expect to be happy, but in fact grow less happy and yet do not abandon habits we know to be both psychologically and ecologically destructive). “[Q]uadruple-garaged mansions, vast malls, [and] gated communities” are among the consumer-driven developments that Farrelly discusses. *Id.*

<sup>154</sup> CAL. GOV’T CODE § 65561 (West 2010).

<sup>155</sup> Securitized mezzanine loans—and the commercial laws that enable them—facilitate development that can create devastating environmental costs without always creating whatever value is associated with new housing. For example, developers may prepare land for development by constructing graded roads and clearing off trees but then delay or abandon plans for actual home building. See HAYDEN, *supra* note 7, at 18–19.

<sup>156</sup> See *supra* text accompanying note 115.

mortgages do not create the same degree of leverage that mezzanine loans do. If junior mortgages are like spraying some WD-40 on the gears of building developments, mezzanine finance is like treating development with an advanced, friction-eliminating chemical.

The details of securitized mezzanine finance may seem ancillary in relation to forces like, for example, federal subsidies for automobile dependency and residential mortgage financing. Yet focusing on real estate finance practices could enable greater sensitivity to the pace and desirability of suburban developments. So long as suburban sprawl remains a controversial topic, perhaps commercial finance rules should not maximize opportunities for leverage that can accelerate development beyond the pace of important collective decisions about land use and the built environment.